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FINANCIAL DEREGULATION IN A GLOBAL ECONOMY
PART II

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A Market Approach to Banking Regulation

Jerry L. Jordan

The cost of complying with regulatory requirements and prohibitions is a major problem for banking today. Regulations imposed with even the best of intentions entail substantial costs, many of which are unintended. These costs, in effect, constitute a tax on the business of banking. As with all taxes on business, the true burden is shared by investors in the form of reduced market valuations of their investment, by employees in the form of lower real wages, and by customers—in this case in the form of higher interest paid on loans and lower interest received on savings. Also, whatever natural comparative advantage depository institutions have in delivering intermediary services is diminished, and businesses and households suffer a reduced menu of financial services. Indeed, the entire economy is harmed to the extent that regulation lowers the efficiency of the financial system and therefore the real growth potential of the economy. Even when regulation is appropriate, its form may matter a great deal.

In this paper I propose ways to modify the current regulatory system, with little or no new legislation, that make greater use of market forces to achieve legitimate regulatory goals while reducing compliance costs.[1] Harnessing market forces for regulatory purposes will lower costs because markets are much more efficient at modifying banks' behavior than regulators could ever hope to be.

These proposals provide incentives for every bank to become a member of a group of banks that are especially well managed and well capitalized. This approach creates a process for lowering the cost

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[1]Legislation is another approach through which the costs of regulatory compliance might be pared. Several bills (H.R. 59, H.R. 269, and S. 265) seeking to reduce the regulatory burden were introduced into Congress early in 1993 (U.S. Congress 1993a; 1993b; 1993c).

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of complying with bank regulation both directly, as banks earn their way into the "quality club" of financial intermediaries, and indirectly, as the need for regulation is reduced by a decline in the risk to the Bank Insurance Fund and taxpayers.

Banks are subjected to a wide array of regulations intended to achieve a variety of purposes. For example, the Internal Revenue Service requires reports on interest paid to and received from bank customers to facilitate and encourage compliance with tax laws; the Treasury Department requires reports of large currency transactions to help detect illegal activities; and agencies that provide government guarantees on loans require special documentation for those loans to protect the government's interests. Some regulations require banks to inform customers of bank practices, some are intended to protect mortgage applicants and other borrowers, and some seek to foster bank "safety and soundness." The broad array of regulations can be divided into four categories: (1) those intended to provide the government with information about its citizens; (2) those intended to lower the costs of information to customers of depository institutions; (3) those intended to achieve some social or political goals; and (4) those intended to facilitate maximum long-run sustainable growth. My proposals concern only that portion of bank regulation that is intended to foster safety and soundness so as to achieve the highest rate of growth that is sustainable in the long run.

Within that limited scope, my proposals would move the bank regulatory system closer to the Securities and Exchange Commission's (SEC) information and disclosure approach to supervision, which I believe is more efficient than the permission, denial, and instruction approach that is the norm in banking. These two regulatory systems are, in essence, competing with each other through the firms that they affect—banks on the one hand and nonbank financial services firms on the other. If the bank regulatory approach burdens banks more than their competitors are burdened by the SEC approach, after taking into account the benefits that banks get from the federal safety net, banks will be at a cost disadvantage in offering financial services to customers. Firms not subject to bank regulation will use their cost advantage to entice customers away from banks. Thus, bank regulation generally will not prevent customers from obtaining financial services, but will increase the likelihood that those services will be obtained from nonbank sources. The proliferation of alternatives to banks in recent years suggests that the SEC approach is superior and that a shift of sources is indeed occurring. The increasing availability of bank-like services from finance companies, mutual funds, brokerage houses, and insurance companies suggests that regulated depository

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institutions are holding on to a shrinking share of the intermediary services market. Economists do not lament sourcing shifts caused by differences in the efficiencies of suppliers, but shifts that result from government-imposed handicaps waste scarce resources. Therefore, it would be in the public interest if more efficient regulatory methods were adopted to achieve the legitimate aims of bank regulation, while relying on natural comparative advantage to determine the outcome among equally supervised competitors.

Origins of the Regulatory Problem

In large measure, the origin of excessive regulatory costs in banking lies in the early 1930s, when more than one-third of U.S. commercial banks failed. Congress responded in 1933 by creating federal deposit insurance for banks and thrifts and by prohibiting them from engaging in certain activities that Congress believed were too risky for insured depositories. Federal deposit insurance was an integral part of the Glass-Steagall Act. Originally, it covered only $2,500 per account, but by 1980 the limit was $100,000, nearly five times the original amount after adjustment for inflation. This may have been done with the best of intentions, but it has had major unintended negative consequences.

Lest we use our 20-20 hindsight to be too critical of the Congress of 60 years ago or even 13 years ago, it is worthwhile to remember that some well-respected scholars formerly saw great merit in a basic level of deposit insurance. Milton Friedman and Anna Schwartz, for example, describe federal deposit insurance as "the structural change most conducive to monetary stability" (1963: 434), and "a form of insurance that tends to reduce the contingency insured against" (1963: 440).[2] Moreover, part of the adverse outcome of the deposit insurance experiment was a result of forbearance in administering regulations, not of regulation per se.

The most visible negative consequence was the recent massive losses suffered by the Federal Savings and Loan Insurance Corporation (FSLIC) in the savings and loan debacle. In the late 1970s, when inflation drove deposit interest rates to very high levels, many S&Ls suffered major losses because most of their assets were low fixed-rate, long-term mortgages funded by short-term deposits on which they had to pay higher and higher rates.

As continuing losses drained their capital, managers of many S&Ls that had become de facto insolvent tried to rescue their institutions by making new, very risky, higher-rate loans that held the possibility

[2]Schwartz has since revised her views on the stabilizing effect of deposit insurance. See Schwartz (1988).

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of being very profitable. They were able to finance these risky, high-rate loans with relatively low-cost deposits because deposit insurance removed from depositors any incentive to be informed or concerned about the riskiness of the loans that their deposits were funding (Kane 1989).

Some managers were successful in saving their institutions with this strategy, but a large number of institutions suffered further losses from risky loans that went sour. In the end, about one-third of the asset values in the thrift industry disappeared, losses in failed thrifts exceeded the resources of the FSLIC, and general tax revenues were used to honor depositors' claims.

In effect, establishing deposit insurance at high levels and forbearing on capital-deficient firms created a moral hazard that turned out to be very costly to the insurance funds and the taxpayers (Woodward 1992; Thomson 1993). Congress then sought to protect the taxpayer by reducing the moral hazard in banking by more stringent safety and soundness regulation of banks and by circumscribing the latitude of regulators to engage in forbearance with troubled depositories. The most significant recent legislation of this type for commercial banks was the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Thus, the FDICIA was primarily a reaction to the huge losses in the FSLIC and the perceived impending insolvency of the Bank Insurance Fund. Congress was determined to do something to minimize the exposure of the Bank Insurance Fund.

What is missing in bank supervision and regulation is a sufficient distinction between well-capitalized, well-managed institutions and marginally capitalized, inadequately managed ones. New powers and exemptions from some regulations can be granted to the strongest institutions while still achieving the aims of legislation. An appropriate distinction would take a triage approach, as follows:

- Banks that are terminally ill should be closed promptly lest they needlessly absorb scarce examiner and deposit insurance fund resources. The FDICIA took important steps in this direction with its prompt corrective action requirement that closes banks whose capital-to-assets ratio falls below 2 percent.
- Banks that clearly are healthy should be exempted from much "safety and soundness" regulation, lest they needlessly absorb scarce examiner resources and waste their own resources complying with regulations that are inappropriate for institutions in their condition.
- Banks that are sick but potentially viable are the ones where supervisory efforts should be focused, to try to restore them

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to health and to prevent them from sliding into the terminally ill category.

Unfortunately, current supervisory policy has regulators treating healthy banks essentially the same as banks that are sick but potentially viable.

The High Cost of Bank Regulation

The cost of compliance with regulatory requirements includes both the explicit costs of meeting regulatory requirements and the implicit costs imposed by regulatory prohibitions. Both costs are large, but are often overlooked in the heat of concern about bank safety. Indeed, it sometimes appears that there is now zero tolerance for losses to the Bank Insurance Fund, rather than a sense that the costs of losses should be weighed against the costs of avoiding losses.

Various studies have estimated that the costs of regulatory requirements range from 6 percent to 14 percent of commercial banks' non-interest expense (Federal Financial Institutions Examination Council 1992: C-15). Banks' non-interest expense was $130.9 billion in 1992, suggesting that their regulatory compliance cost in that year was between $7.9 billion and $18.3 billion. That compares with industry earnings in 1992 of $32.2 billion.[3]

However, these estimated costs of regulatory compliance exclude four important categories of additional costs: (1) the opportunity costs of holding excessive non-interest-bearing reserves; (2) the costs of the additional requirements now mandated by the FDICIA; (3) the costs to the banks and the economy of forgoing the profits and efficiencies that would have resulted if banks were not prohibited from various activities and locations; and (4) the costs of treating banks as vehicles for achieving social and political goals.

Looking first at reserve requirements, there is an opportunity cost to holding excessive non-interest-bearing reserves in Federal Reserve Banks. Any calculation of that cost must consider that banks use their reserve balances for clearing purposes and, in the absence of reserve requirements, would incur other costs of clearing. However, the cost of required reserves is not the relevant concern. The appropriate concern is the wedge that reserve requirements create at the margin, hampering banks in their competition with providers of loans and deposit-competing assets that are not required to hold idle reserve balances.

[3]Bank earnings and non-interest expense data are from Federal Deposit Insurance Corporation (1992).

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Second, the additional requirements of the FDICIA will add to the cost of regulatory compliance. That addition is likely to be substantial, considering the 60 or so working groups at the regulatory agencies that have prepared or are preparing regulations to implement the FDICIA, and the costs of complying with some regulations already issued.

Third, there are costs to banks and to the economy of prohibiting banks from entering certain activities and locations. Those costs are hard to measure, and while no estimates of such costs are available, they, too, are likely to be substantial. When banks are prohibited from entering certain locations, their balance sheets tend to have less geographic and industry diversification, which reduces their soundness and their profitability. Similarly, when banks are prohibited from entering certain activities, banks have less product diversification, which also reduces their soundness and their profitability.

Those prohibitions impose costs on the economy. Restricting banks from entering certain activities and certain geographic areas might reduce the degree of competition in those products and areas, reducing efficiency. However, efficient-market theory suggests that other financial firms will enter those activities and serve those areas, so it is possible that substituting nonbanks for banks would minimize the loss of efficiency. On the other hand, if some bank economies of scope are lost because of prohibitions, the efficiency loss is increased.

There is a cost to the public of providing to depository institutions the subsidy implicit in the federal safety net. The safety net includes federal deposit insurance, access to the Federal Reserve discount window, and Federal Reserve provision of intraday credit through its operation of the nation's payment system.

The subsidy to banks embodied in the federal safety net, and the consequent web of regulations, causes some people to think of banks differently than they think of most other private firms. Banks have even been likened to persons on welfare—as long as they are receiving the subsidy implicit in the federal safety net, they must do what government tells them to do. Representative Henry B. Gonzalez (D.–Tex.), chairman of the House Banking Committee, has said that "When you're on relief, there are lots of rules. Just ask the poor folks on food stamps."[4] A variant of this view is that banks should be treated as public utilities.[5]

[4]Quoted by Barbara Rehm (1992: 14).

[5]For example, Albert Wojnilower (1993: 4–5) asserts that "Both the payments and the credit system have been and should continue to be regarded and treated as public utilities. Banks should not be required, encouraged, or even allowed, to withdraw from lending and

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Consequently, some people want to treat the banking system as an instrument for achieving social and political goals. They see banks as a vehicle for gaining access to financial resources through the political process rather than through competition for funds based on the merit of the investment. One example is the call for a national investment policy that was heard a few years ago. Another is the efforts of consumer-oriented individuals or groups, using leverage provided by the Community Reinvestment Act (CRA), to reach agreements with banks to make loans or investments favored by those groups. Sometimes such efforts result in a less efficient allocation of scarce resources. The morally valid objective of the CRA—to improve the flow of credit to all neighborhoods in a community—can be impeded when the requirements for compliance become an instrument for seeking resource redistribution that was not intended by the legislation.

Achieving Regulatory Objectives by Using Market Forces

Large cost, per se, does not prove that regulation is unwise. Clearly, so long as bank deposits are protected by federal insurance, regulation to control taxpayer exposure to loss is necessary. However, the high cost of compliance with bank regulation does strengthen the argument for analysis to determine if the benefits of regulation exceed the cost.

Even without a cost–benefit analysis, which is beyond the scope of this paper, it is clear that lowering the cost of achieving regulatory goals is desirable. The Federal Financial Institutions Examination Council's (FFIEC) *Study on Regulatory Burden* (1992) generated a list of suggestions for reducing regulatory compliance costs, many of which I support. Beyond these recommendations, however, there are several ways that market forces can be used to further the same goal.

One of the major purposes of regulation is the promotion of bank safety and soundness, in order to protect customers, the Bank Insurance Fund, and taxpayers from bank failure. Most of my suggestions are about ways to use market forces to reduce the cost of pursuing that goal and to increase the degree to which that goal is achieved. Adopting these suggestions will foster a stronger and more efficient banking and payments system, which is consistent with the overall goal of maximizing sustainable, long-run economic growth.

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maturity transformations, any more than an electric utility would be permitted to withdraw service from part or all of its territory. For banks, as other utilities, we should limit competitive access, assure adequate but capped returns, and restrict ventures in unrelated fields."

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Perhaps the broadest approach to limiting the risk to the Bank Insurance Fund while freeing banking organizations to compete freely in all facets of the financial services industry would be to reorganize the banking industry along the lines of a narrow bank—broad bank dichotomy. That proposal envisions the creation of a narrow, or core, bank that accepts transaction deposits, invests only in short-maturity, highly liquid assets, offers a narrow range of services to its customers, has deposit insurance, and is supervised by an organization such as a Federal Reserve Bank.[6] The narrow bank could not engage in riskier lending or offer other financial services, which instead could be offered by separately incorporated, non-federally insured subsidiaries within the same financial services holding company. The intention is that these other subsidiaries would receive no benefit from and would pose no risk to the Bank Insurance Fund and therefore would not need to be subject to regulation by banking authorities. This approach would be a substantial departure from the present banking system and would require major new legislation.

If we assume that there will be no such major change in the powers and structure of banking organizations, then the broadest approach to using market forces to achieve the goals of regulation would be to eliminate or greatly reduce deposit insurance, or to introduce coinsurance, while taking steps to expand the amount of information about banks that is available to depositors and creditors. More depositors would then take an interest in the soundness of banks, and banks would have to demonstrate their soundness to attract deposits. This proposal has been discussed at length elsewhere, so I will not elaborate on it here.[7] Even though this approach makes good economic sense, substantial political barriers stand in the way of its adoption. Therefore, for the purposes of this paper, something like the present deposit insurance system is reluctantly taken as a given.

There is one action, however, that could be taken right now that would make reduction or removal of deposit insurance more feasible in the future. That action would be to implement a proposal, which will be detailed below, for providing the public with additional information about the condition of individual banks. This would overcome one of the political objections to the removal of deposit insurance, namely,

[6]Proponents of this approach and its variations include Milton Friedman (1960: 65–75), James Tobin (1987), Robert Litan (1987), and Lowell Bryan (1991). Ronnie Phillips (1992) discusses the influence of this proposal on banking legislation in the 1930s. Critics include Bert Ely (1991) and Donald Simonson (1991).

[7]For a discussion and brief bibliography on the subject, see W. Lee Hoskins (1989) and James Thomson and Walker Todd (1990).

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that depositors do not have sufficient information to evaluate the soundness of the banks in which they keep their money.

Risk-based deposit insurance premiums are a move in the right direction. The Federal Deposit Insurance Corporation (FDIC) recently implemented a risk-based premium assessment system that bases deposit insurance rates on each bank's capital and supervisory rating. These risk-based premiums will provide a market incentive for banks to improve the quality of their assets. However, as long as the insurance provider is a public agency, it is unlikely that political considerations would permit a range of deposit insurance premiums wide enough to fully reflect differences in risk, or that such premiums would be changed promptly when the condition of a bank changes.

The FDICIA's provisions and requirements for prompt corrective action, including regulator-mandated merger or closure, also move in the right direction and should reduce the Bank Insurance Fund's and the taxpayers' exposure to loss. Of course, there is some deadweight loss caused by the act of seizing a bank. Opinions differ about how much of those losses are merely the realization of embedded but concealed losses. If the costs of seizure are large, the Bank Insurance Fund might still incur losses, but the size of such seizure losses would be much smaller than for pre-FDICIA closings because early intervention itself reduces the final loss. Certainly there is no reason to believe that bankruptcy costs will be larger under early closure than they were with delayed closure before the FDICIA.

Seizure by regulators becomes necessary when bank and regulator efforts to maintain soundness have failed. I want to focus on what can be done, assuming deposit insurance remains in place, to use market forces to reduce the cost of regulatory compliance and/or to increase the safety and soundness of banks. That is, I want to consider how the carrots and sticks of the market can be used to induce banks to become safer of their own accord, rather than through the micromanagement efforts of regulators. To some people, the concept of market forces regulating an industry sounds like an oxymoron. Doesn't regulation have to be carried out by a regulator, by a government agency? Indeed not. Market forces are powerful and efficient regulators.

Disclosure of Ratings as a Marketing Tool

Good planning by individuals and firms is facilitated by access to information that is accurate, adequate, and timely. Therefore, one approach I want to suggest for using market forces for bank regulation is to require the disclosure of bank CAMEL and bank holding company BOPEC ratings, so that bank customers can make informed plans and

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decisions about where to do their banking business.[8] Such disclosure is now prohibited by regulatory decision, but is not clearly prohibited by law.

Regulatory agencies could prepare ratings in a form that is suitable for dissemination to the public. This might be in a summary rating or grading form such as is used for public disclosure of CRA ratings. Banks already are required to make their CRA evaluations public within 30 days of receipt.

In addition, I propose that the bank regulatory agencies publish a quarterly list of insured banks and their respective capital categories that regulators have assigned for purposes of the prompt corrective action (PCA) provision of the FDICIA. These categories are determined principally by banks' capital ratios, which are derived from publicly available financial information.[9] However, capital categories are also influenced by other information available to the regulatory agencies, such as applications filed, reports required under other banking and securities laws, and state examination reports. Thus, the PCA capital categories in some cases reflect a more current risk profile than does the last available examination rating.

Similarly, the FDIC should publish a list of insured banks and their respective Assessment Risk Classifications (ARC), which are used to determine risk-based deposit insurance premiums. This risk measure is also determined by capital ratios and regulators' supervisory risk ratings. The Federal Reserve Board and the FDIC have chosen to prohibit depository institutions from disclosing PCA capital categories or ARCs. However, the law does not require the agencies to impose this prohibition.

Disclosure of a good risk rating could be an important marketing tool for banks, so banks would have increased incentive to earn a good rating. Market forces would reward highly rated banks with some reduction in deposit interest rates, especially for uninsured deposits, relative to those that banks with lower ratings would have to pay. This would not reduce the cost of complying with safety and soundness regulations, but would use market forces to increase the benefits of being safe and sound.

Releasing ratings would also put pressure on regulators to rate banks accurately. A regulator who repeatedly failed through its ratings

[8]CAMEL and BOPEC are acronyms for rating reports issued by regulators on banks and bank holding companies, respectively. A bank's CAMEL rating is based on evaluations of its *C*apital, *A*sset quality, *M*anagement, *E*arnings, and *L*iquidity. A bank holding company's BOPEC rating is based on evaluations of its *B*ank subsidiaries, *O*ther (nonbank) subsidiaries, *P*arent company, *E*arnings—consolidated, and *C*apital adequacy—consolidated.

[9]The data can be found in a bank's Report of Condition and Income, often referred to as

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to make timely identification of negative trends in bank soundness would be called to account by the public and, in the case of a Federal Reserve Bank, by the Federal Reserve Board of Governors and the Reserve Bank's own board of directors.[10]

Requiring disclosure of bank rating information would put in place a condition that would make the eventual curtailment of deposit insurance more practical, because depositors would have access to the information necessary to protect themselves. For this procedure to be equitable, the supervisory agencies would need to coordinate to ensure that they were all using the same criteria for assigning ratings. Uniform standards are critical for this proposal to be successful, and for it to be supported by the banking community.

A supplement to requiring release of regulator ratings would be to encourage banks to voluntarily disclose aggregated data from their internal classifications of loan quality. This disclosure could be accompanied by estimated market or recovery value of loans in the bottom few classes, as well as by income nominally due and income actually received from those classes. This would enable investors to judge more accurately the value of the common stock of the disclosing banks, and would be a step closer to the SEC disclosure approach to supervision. Willingness to make this information public could be a condition for participation in the other portions of this experiment in a market approach to banking supervision.

Regulatory Cost Reduction

A second approach is that banks that have top CAMEL ratings and that are especially well capitalized—that is, those that exceed by some 20 or 30 percent the thresholds now used by regulators for considering an institution to be well capitalized—could be given some relief from the frequency and intensity of examinations intended to enhance their safety and soundness.[11] Less regulatory oversight is needed to ensure the safety and soundness of especially well-capitalized banks. Indeed, for sufficiently well-capitalized banks, one might ask why there should be *any* safety-and-soundness-oriented regulation.[12]

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the Call Report, which banks are required to file quarterly with their primary regulator.

[10]The Federal Reserve System's regulatory authority is generally vested by law in the Board of Governors, which delegates authority to the Reserve Banks.

[11]Regulators now consider a banking company to be well capitalized if it meets the following criteria: (1) Total risk-based capital ratio is 10 percent or above; (2) Tier 1 risk-based capital ratio is 6 percent or above; (3) Tier 1 leverage capital ratio is 5 percent or above; and (4) The institution is "not subject to any . . . capital directive . . . to meet and maintain a specific capital level for any capital measure." See Federal Register (1992: 44,886). For definitions of these ratios, see Board of Governors (1989).

[12]After this paper was written, the four federal regulators of banks and thrifts announced

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We can reduce the burden of that portion of the examination process that determines asset quality by placing greater reliance on those banks' own internal systems of loan quality review and reporting, after supervisory verification of the adequacy of the internal loan review systems. That would mean fewer officer-hours would be required to assist examiners in reviewing loan documentation. Similarly, in the case of banks that have strong internal controls and audit systems, there would be less need for examiners to review for compliance with various laws and regulations. Moreover, banks that are especially well capitalized and that have in place interest-rate-risk measurement systems that examiners have reviewed could be exempted from having to establish and use the standardized interest-rate-risk measurement system currently being devised by the regulatory agencies.[13] These approaches would reward good management and strong capitalization while having no deleterious effect on safety and soundness. By giving banks added incentives to be safe and sound, we would promote those objectives. Still another change would be to reduce the frequency of examination of such banks to greater than 12-month intervals, although this would require legislation, because the FDICIA now mandates annual exams.

The opportunity for gaining reduction in regulatory compliance costs would provide an incentive for less well-capitalized banks to improve their capital-to-assets ratios so as to qualify for this preferential treatment. Of course, this incentive would increase the need for accounting measures that accurately represent a bank's true situation. For banks that do qualify, the reduction in regulatory costs would increase their return on assets and equity, lower their cost of capital, and enable them to expand and thereby pressure other banks to become better capitalized and better managed.

Streamlining Regulatory Procedure

A third opportunity would be to establish a greatly streamlined regulatory procedure for certain bank mergers and acquisitions or for nonbanking activity expansions involving especially well-capitalized, well-run organizations. Such an organization that wanted to acquire

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that they ". . . are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending." See Office of the Comptroller of the Currency et al. (1993: 1). One part of that program could be added to the proposals in this paper. That part says that "Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans [to small businesses] with minimal documentation requirements, consistent with applicable law" and that there would be a limit ". . . on the aggregate of such loans a bank may make" (Ibid.: 2).

[13]A similar suggestion is made by Stephen LeRoy (1992).

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another bank or engage in a nonbanking activity that the Federal Reserve Board had already deemed permissible would only be required to submit a letter notifying the appropriate supervising agency of its intentions and describing the activity.

To implement this procedure, the agencies would publish a list of qualifying criteria for the applicant and for the transaction or activity expansion. For example, in the case of a bank holding company acquisition of a bank, the applicant must be well capitalized, all of its banks must have at least a satisfactory CRA rating, and the transaction cannot raise any legal or competitive issues. The notice would briefly describe the transaction and certify that the criteria set forth by the supervising agencies are satisfied.

The Federal Reserve System already has taken this approach by reducing the regulatory requirements for state member banks to establish branches to a simple letter of notification and the required newspaper notice. Similarly, in 1992 the Federal Reserve published criteria for exempting a bank holding company from filing an application with the Federal Reserve if it is also filing a bank merger application with another banking regulator for what is essentially the same transaction. Normally, a bank holding company acquiring a bank must file an application with the Federal Reserve. When a holding company acquires a bank and immediately merges it into a bank that it already owns, it must also file an application with the regulator of the surviving bank. An exemption from filing with the Federal Reserve is available for those transactions.

To implement this concept would require some changes in the way the agencies deal with CRA comments and objections from community groups. Applications are sometimes significantly delayed when protests are submitted with respect to banking institutions' CRA performance. A considerable amount of time, correspondence, and sometimes public hearings are required to resolve issues raised in protests. In some cases, delays in applications processing result because the regulator was not aware of the issues at the time the banks were examined for CRA compliance.

The way regulatory agencies assess banks' CRA performance could be greatly improved by soliciting comments from community groups as part of the regular examination process and not solely in the applications process. The agencies could provide public notice of scheduled CRA examinations and give interested parties an opportunity to submit comments in writing or to request a meeting with the examiners. If the banking organization receives a good CRA rating and subsequently files an application, any CRA protest about that application would be considered substantive only if the commenting party could show good

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cause why the comments were not submitted during the regular examination process or why the commenter believes that an issue raised previously has not been resolved.

This proposal is consistent with the 1989 Interagency Policy Statement on CRA that encourages community groups to bring their concerns to the attention of the bank and its supervisory agency at the earliest possible time (Federal Reserve Board et al. 1989: 13). In this way, issues can be resolved in a more timely and orderly fashion. Moreover, community groups would be given direct input into the CRA rating process. Banking organizations that receive good ratings, considering the broader input from community groups, would then be reasonably assured that their applications will not be delayed.

Rewards for Source-of-Strength Commitment

A fourth opportunity for using market forces in banking supervision is that bank holding companies with top BOPEC ratings that are especially well capitalized and that are willing to give to the Federal Reserve explicit, legally binding commitments to be a source of strength to their banks could be rewarded in several ways. One way would be to simplify the examination of their subsidiary banks, at least to the extent that the holding company's separate capital could support those banks. Capital requirements, requirements for financial reporting and review, loan policy and supervision, etc., could be satisfied at the holding company level instead of having to be done at the level of each individual bank. Similarly, with the same binding source-of-strength commitment, restrictions on interbank liabilities and determination of deposit insurance premium rates could be set at the holding company level rather than at the subsidiary bank level. In addition, banking supervisors could expand the list of nonbanking activities considered permissible for the nonbank subsidiaries of bank holding companies that have given source-of-strength commitments. Finally, supervisory agencies could give such subsidiaries more leeway to engage in securities underwriting and other limited activities by raising to 49 percent (from the current 10 percent) the limit on the share of a separately capitalized subsidiary's revenue that can be derived from that activity without being considered in violation of the prohibition against being "principally engaged" in that activity. Some of this would require changes in legislation.[14]

[14]The four federal regulators of banks and thrifts have agreed that, to reduce the burden of the examination process, they will ". . . establish procedures to centralize and streamline examination in multibank organizations," but they give no details on how that will be accomplished. See Office of the Comptroller of the Currency et al. (1993: 5). The relevant proposals in the present paper can be viewed as specific procedures that are consistent with that objective.

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In summary, adoption of these four proposals would reduce the costs of regulatory compliance while providing positive incentives for banking companies to increase their safety and soundness. That would improve earnings, enable the banks to attract capital more easily, and thereby enhance their safety and soundness and their ability to expand, which would pressure other banks to become safer and sounder in order to increase their own competitiveness. Therefore, the regulatory relief from these proposals might prove to be larger than it initially seems, because as other banking companies respond to the incentives and become highly capitalized, they too will receive the benefits.

An additional advantage of these proposals is that they would require less regulatory attention to be given to banking companies that need less attention, which would allow some regulatory resources to be redirected to giving closer attention to those banking companies that are more in need of it.

Testing the Market-Forces Approach

I believe that each of these four approaches should be tested by the regulators. That is, I propose that (1) banks be required to release their examination ratings to the public, and be required to release their internal loan quality assessments in aggregate form as a precondition for participating in the other portions of the test; (2) companies with top CAMEL or BOPEC ratings that are especially well capitalized be given relief from some regulatory requirements; (3) applications from companies with top CAMEL or BOPEC ratings that are especially well capitalized and that have good CRA ratings be given expedited treatment with a presumption in their favor; and (4) bank holding companies with top BOPEC ratings that are especially well capitalized and that give binding source-of-strength commitments be rewarded with supervision at the holding company level instead of at the subsidiary bank level. Although it would be desirable to test all four approaches, no one proposal is dependent on any other.

Most of these proposals require no change in legislation. In those cases where a legislative change is required, it would be desirable to have legislation that enables the experiment to go forward and that provides for an evaluation of the results to be used as a guide to final legislation.

A test of these proposals on a small scale would have three advantages. A test is less costly than a nationwide experiment. Changes and refinements can be made more quickly. And, because it will be clear to all concerned that it is a test and not a change in policy, it will be politically easier to reverse course in the unlikely event that the test

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is unsuccessful. Consequently, I believe the test should be done in a region of the country rather than nationally. A Federal Reserve District would be a logical site. The test should continue for at least three or four years—and ideally through a full business cycle—so that its success can be sufficiently evaluated.

Several criteria can be used for evaluating the outcome of the test. If this new approach is valuable to banking institutions, there will be some shift of deposits to those banks that publish good ratings. The shift will be moderated to the extent that deposit insurance still exists and by the likelihood of a spread developing between the deposit interest rates paid by high-rated and low-rated banks. In addition, earnings of especially well-capitalized and well-managed institutions in the test region should rise relative to the earnings of similar institutions in other regions (adjusted for other factors that affect earnings). Moreover, the ratio of market value to book value for those institutions should rise relative to those outside the test area, while operating costs should show a relative decline. Especially well-capitalized and well-managed bank holding companies outside the test area will be pressing their banking supervisors to adopt the approaches being used in the test. Also, if this approach to supervision is valuable to customers, there will be a greater expansion of bank products and services in the test area than elsewhere. Finally, trends in measurable indicators should emerge if this approach to supervision enhances the safety and soundness of institutions in the test area. Among them are (1) capital-to-asset ratios will rise; (2) the number of bank failures will fall, although initially there might be a jump as weak banks are culled; (3) credit ratings will rise; (4) the cost of issuing subordinated debt will fall; and (5) the interest rate on large (uninsured) certificates of deposit will fall relative to national averages.

Conclusion

In summary, the cost of complying with bank regulation is high, making it important to find ways of reducing that cost while still achieving appropriate regulatory goals. Market forces can be used to lower the costs of regulation while enhancing the achievement of the regulatory goals of ensuring safety and soundness and fostering an efficient banking and payments system. Those improvements will help achieve greater efficiency and growth for our economy. I believe that a test of these proposals should be undertaken, and should be started promptly.

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A Market Perspective on Financial Regulation

Edward J. Kane

I want to salute Jerry Jordan for standing up on behalf of the market approach to banking regulation. The idea of intensifying the exposure of federal banking regulators to rules and timely market discipline has historically found few adherents among the top officials of the Fed.

For federal banking regulators, the watchword has been discretionary flexibility rather than accountability. U.S. financial regulators have prototypically portrayed themselves as vigilant and farsighted public servants who can always be relied upon to use their discretion in the best interests of the "public." Given this utopian party line, market, budgetary, and statutory constraints on the short-run exercise of regulatory discretion are routinely condemned on the grounds that they are bound to cause suboptimal long-run regulatory performance.

In fact, the longstanding decline in banking-industry share of financial activity and losses incurred in state and federal deposit-insurance messes have both been amplified by short-sighted abuse of regulatory discretion. This abuse creates a strong case for placing tighter discipline on banking regulators. The idea is to lessen the painful conflict that now exists between long-run societal and industry interests and the short-run personal and bureaucratic interests of top banking regulators.

To improve long-run regulatory performance, longstanding defects in regulatory incentives must be repaired. At a minimum, this means enhancing the capacity of U.S. labor and financial markets to monitor and discipline the discretionary actions by which elected and appointed officials systematically reward weak clients and punish strong ones.

Jordan's Four-Point Program

Jordan sees that accountability reform must begin with timely disclosure of the information base from which regulators operate. Full and

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immediate disclosure of examination and other regulatory ratings would allow the press, academic researchers, bank creditors, and bank customers to help taxpayers to monitor and discipline regulatory behavior more effectively. For this reason, I have for several years advocated that banks be allowed to post their most recent regulatory ratings underneath each federal deposit-insurance seal that they display in banking offices.

The other three elements in Jordan's program seek to impose mild "action-forcing rules" on regulators, rules formulated to be conditional on the information being disclosed. The second and third items in his program would constrain regulator discretion by explicitly requiring that high-rated institutions receive less-burdensome supervisory monitoring and enjoy specific regulatory privileges. Jordan proposes to grant strong banks expedited reviews of their requests for new powers and for changes in organizational structure.

The final element in his program would offer privileges to strongly capitalized bank holding companies that voluntarily make a binding pledge to adhere to the source-of-strength doctrine that in the past the Fed has sought inquisition-like to force upon the industry.

The Market for Financial Regulatory Services

Financial regulation is a service that clients value for the benefits of confidence and convenience that it confers on customers who use the client's products. The failure of the Fed's source-of-strength doctrine to win converts in the absence of a quid pro quo for adherents illustrates the nature of transactions that occur in the market for regulatory services. In this market, the Fed is only one of many domestic and foreign suppliers.

Although the policy literature speaks of regulatory "requirements," this word is a misnomer. Regulators do not and cannot autonomously "command and control" the behavior of the client institutions they regulate. Rather, each regulator's "controls" are shaped by prior conditioning and ex post feedback from the parties it regulates. To survive, a control must be voluntarily accepted by regulatees in the long run. Unacceptable controls lead regulatees and their competitors to engage in "regulatory arbitrage" that effectively transfers market share from inefficient to efficient suppliers of regulation.

The long-run voluntariness of regulatory relationships underscores the parallels that exist between operating a regulatory agency and operating an ordinary business. To succeed in the long run, each regulatory enterprise must deliver a quality product at a fair price.

The equivalent of the price of a regulatory system is the net burden it places on its regulatees. This net burden differs from the "gross

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burden" of regulation in two ways. First, it subtracts out the benefits in customer confidence and transactional efficiency that a regulator confers on its regulatees. Second, it further eliminates any costs of operating the regulatory system that can be successfully shifted to unwary taxpayers.

As a price, each regulator's net burden responds over time to opportunities for substitution. Competition from differentially regulated institutions and other market forces lead regulated parties to do two things: (1) to lobby for less-burdensome rules, and (2) to adapt their economic strategy and organizational form to reduce the opportunity costs that the regulation would create for their firms if managers were to comply with existing rules mindlessly. For this reason, the cost of inefficient regulation tends over time to shift from costs of strict "compliance" to costs of regulatory arbitrage. The cost of regulatory arbitrage is the cost of adapting a regulatee's product line, production and distribution systems, business locations, and corporate structure to make it legally possible to engage in profitable activities from which the firm would otherwise be excluded.

Interstate banking exists, even though interstate branching remains limited. A bank's holding-company affiliates engage in many activities from which banks themselves are legally excluded. The advantage of relaxing for strong banks what are outmoded restrictions on locations and activities and routinizing administrative reviews of structural-arbitrage proposals is that this would eliminate some economically inefficient bank expense. But it does not promise to optimize the burden placed on strong banks.

Wisdom of Relaxing the Net Burden for Strong Banks Only

Between 1950 and mid–1992, the share of U.S. financial assets held by domestically chartered banks shrunk from 50.5 to 20.4 percent (Barth and Brumbaugh 1993). This decline is due partly to expansion in bank off-balance-sheet activity, but also to changes in information technology that open up bank markets to foreign and cross-industry domestic competition and inefficiencies in federal banking regulation.

Net regulatory burdens differ drastically between strong and weak U.S. banks. Weak banks receive subsidies from deposit insurance that strong banks eventually help to pay for. The net burden of strong banks has increased secularly in two respects. First, social-purpose regulation (whose benefits are directed outside the industry) has generated an increasing paperwork burden. Second, regulatory efforts to retard the exit of inefficient and insolvent deposit institutions lower

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the profit margins strong firms can earn and push their deposit-insurance premiums above the value of the guarantee services these low-risk institutions receive.

In explicitly seeking to lower the net regulatory burden for strong banks, Jordan's program takes an important step. However, it does not specifically seek to equalize the net regulatory burden for strong U.S. banks with that of competing financial-services firms or to equate the part of the burden banks shift to taxpayers with the benefits of the social responsibilities banks are asked to shoulder. One way or another, the law of one price tells us that market pressures on U.S. banks and banking regulators will accomplish both types of equalization in the long run. The question is how much of U.S. bank's financial-market share will have to be transferred to foreign firms and domestic nonbank financial institutions in the meantime.

A Four-Part Program of Market-Based Regulatory Reform

Like Jordan, I have a four-part program for regulatory reform. It also combines requirements for information disclosure with action-forcing rules. My approach to information reform recognizes that a central task of most bureaucracies is to cover up emerging evidence of mistakes. It is necessary to increase the timeliness and accuracy of information supplied by managers of insured institutions, managers of deposit insurance funds, and politicians to reduce opportunities for administrative coverups of accruing losses. So that markets can discipline managerial mistakes in timely fashion, I would make it a legal duty for regulators to report taxpayers' loss exposure in their enterprise. I recommend the adoption of self-reporting and market-value accounting principles for measuring periodic performance and taxpayer loss exposure at all regulated firms and regulatory agencies. As with the reporting requirements citizens face under the federal income tax, I would enforce these principles by establishing civil and even criminal penalties for managers who could be shown at any time to have willfully provided less than their best estimate of their enterprise's market value and loss exposure.

To reduce the scope for regulators to retard the exit of inefficient and insolvent institutions, I would institute three types of action-forcing rules. These rules would specify what is meant by a regulator's duty of faithfulness to taxpayers and establish mechanisms that would penalize derelictions of this duty.

The first rule would require FDIC managers to recapitalize their insurance funds promptly (i.e., according to a prespecified time table)

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whenever the market value of their enterprise's net reserves falls below a specified minimum. In this way, deposit-insurance losses would be passed through the federal budget as they accrue.

Second, I would lessen the advantages of political incumbency by strengthening electoral challenges of unsatisfactory performers. I would do this by requiring that fifty cents of every dollar in campaign contributions that is raised by an incumbent member of Congress be paid into a party-administered fund used to finance candidates running against incumbents of the opposite party. This would strengthen party discipline, enable new members of Congress to take office without establishing a prior debt to special interests, and shorten the careers of dishonest politicians who would find it hard not to violate this law.

Finally, I would require members of Congress and the administration to acquiesce in three additional requirements: (1) to set explicit limits on their ability to intervene ethically into the process of closing individual institutions; (2) to report all such interventions to congressional banking and ethics committees for explicit review; and (3) to subject committee reviews and regulatory-agency performance accounting to regular evaluation by "disinterested" outside experts.

The prospective difficulty of enacting these reforms is a measure of the depth and stubbornness of incentive defects in banking regulation today. Before they can become desirable to officials, the value of these reforms will have to be appreciated by the electorate. The root incentive defect in representative democracy today is the disincentive for ordinary citizens to go to the trouble of understanding the high long-run costs that their elected and appointed representatives create as they pursue fleeting, short-run benefits.

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Major Threats to the Financial Services Revolution

William A. Niskanen

First, the good news: the financial services revolution is alive and well and will continue to provide valuable new credit and risk-spreading instruments. These new instruments will have important effects on the structure of nonfinancial firms and industries. Maybe more important, the increased globalization of the markets for financial instruments will reduce the exploitive potential of all governments.

Now for the bad news: the major uncertainty is whether American banks will be allowed to participate in this revolution. Our government has recently overreacted to the collapse of the savings and loan insurance fund by a substantial reregulation of both the S&Ls and the commercial banks without, I suggest, adequately addressing the problems that led to the S&L crisis. The major constant is that government will continue to be a part of the problem, not the solution to the remaining real problems. In some cases, the government will protect existing services against the new services, declining firms and industries against the entrepreneurial firms that provide the new services. In other cases, several pending government measures pose major threats to existing financial services and industries. As a specialist in federal economic policy, let me focus on the major governmental threats to this revolution.

Banks

The most visible problem of the commercial banks is a reality, not a threat: Congress has overreacted to the S&L collapse by an extraordinarily complex web of new regulations on the premise, apparently, that if some regulation is desirable, more regulation is even better. Bill Haraf (1992) at Citicorp probably expressed this best in the following words:

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> The architects of FDICIA made sure that virtually every idea anyone once had to enhance the safety and soundness of depository institutions found its way into the law. Let me offer an analogy to illustrate why. An elderly gentleman with a number of vague, but modestly debilitating symptoms arranges appointments to see his internist, a chiropractor, a surgeon, his dentist, a proctologist, and even a faith healer to seek advice about his health. They all recommend programs of treatment based on their training and experience. The proctologist, I might add, proposed a particularly ambitious treatment plan. Confused about the conflicting advice, he undertakes them all. Three months later, after being drugged, reamed, racked, bled, root canaled, purged, blessed, and otherwise tortured, the poor old gentleman died.
>
> FDICIA includes, among other measures, risk-based premiums, early intervention, market discipline from large depositors, Reg Q-type deposit ceilings, brokered deposit and pass-through restrictions, tougher accounting and audit standards, discount window reforms, mandatory operational and managerial standards, closer supervision, higher effective capital standards, enhanced risk-based capital standards, limits on activities of state chartered banks, and more. In addition, burdensome new consumer provisions, such as the misnamed Truth in Saving Act, were also added. Many of the new regulations which found their way into FDICIA were based on sound and useful ideas. In combination, however, they could not be remotely justified by any sensible cost/benefit calculation. Judging from the experience of the elderly gentleman, the prognosis for banking is not good.

And these measures may also have had a serious effect on the general economy, particularly on those firms that do not have direct access to the capital markets. During the first 12 months in which the FDICIA regulations were in place, commercial banks reacted by increasing their holdings of U.S. government security by $99 billion and reducing their commercial and industrial loans (C&I) by $15 billion. This is the first time that this combination of investment patterns has been observed during the early stages of an economic recovery.

C&I loans are now lower, in nominal dollars, than in December 1988, and are now smaller than their holdings of U.S. government securities. My reading of this evidence, which I acknowledge has been disputed, is that we are experiencing a rare combination of a generally expansive monetary policy and genuine credit crunch primarily affecting small business. The package of measures announced by the Clinton administration, involving such minor issues as the conditions for which there must be an appraisal of real estate used as collateral, do not substantially change this condition. FDICIA, a measure designed to make deposit insurance safe for the taxpayers, is transforming banks

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into lenders to the government, a credit function for which the banks have no comparative advantage.

The major new threat to the banks is the potential for credit allocation. The Clinton administration, not satisfied with their power to influence the flow of new saving, is apparently considering measures that would mandate an allocation of some part of the $3 trillion of bank portfolios to politically favored groups—such as inner cities, small business, and racial minorities. The recent charge that banks have discriminated by race in their mortgage lending is especially egregious—a charge that is based on the questionable premise that bankers have foregone opportunities for profit in favor of racial prejudice and that is wholly inconsistent with the evidence that the default rates do not differ by race.

The increase in deposit insurance premiums and regulation has already led some major banks to consider dropping their bank charter. And the new threats to bank portfolios could turn this into a stampede. The American commercial banking industry will and should undergo a major shakeout. The issue is the extent to which this will be a result of ill-conceived government regulation or of market forces.

Insurance Companies

Insurance companies face two major threats. The Clinton administration will apparently propose some form of "managed competition" in health care in which everyone in a region would pay the same premium for a basic package of medical services. This would effectively eliminate any insurance role for the insurance companies. These companies may still provide claims processing services and organize some of the provider networks, but the present system of health insurance would be transformed into a system of medical care prepayment plans with no significant insurance dimension. The transition to this system is also expected to include a several-year period of federal control on both insurance premiums and on provider compensation.

The other major threat is the prospect of federal solvency regulation. A several hundred-page bill that would establish the first federal regulation of insurance company solvency has already been proposed by Congressman John Dingell (D.-Mich.). The primary problem of this proposal is that the states would maintain the authority for rate regulation. The separation of solvency and rate regulation would remove any remaining discipline on the state regulators with the prospect that they would reduce their maximum allowed rates.

There is a way out of this conflict, similar to the dual-chartering system for banks. Insurance companies that opt for a federal charter

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would be subject to federal solvency regulation but would be freed form any state (or federal) rate regulation. Other companies with niche markets would maintain their state charters and continue to be subject to state regulation of both solvency and rates. The proposal by John Dingell should be taken seriously, but there is an opportunity to turn this threat into an opportunity.

Pension Funds

The major threat to pension funds is similar to that for banks—the prospect of federal control of their portfolio of assets. Alicia Munnell, assistant secretary for economics in the Treasury, has long proposed eliminating the tax deduction on pension contributions and accruals. More recently, she has supported direct federal controls on a substantial part of pension assets on the questionable promise that these assets were not sufficiently taxed in the past. Banks and insurance companies should recognize their common interests in opposing these massive potential regulatory takings of their existing assets.

Derivative Markets

The final and continuing threat is the potential for increased federal regulation of the markets for derivative financial instruments. Such measures have long been supported by the Securities and Exchange Commission and some of the major Wall Street securities firms. In retrospect, it seems like a fortunate historical accident that the markets for these instruments have been allowed to develop under the light regulation of the Commodities Future Trading Commission. It would be especially tragic if these markets were subject to increased regulation just when the American business community is learning to use these instruments effectively to reduce the risks in the variance of their input or output prices.

Conclusion

In summary, the problems of the existing regulation of financial markets are serious, will significantly affect the structure of the financial industry, and will delay or reduce the potential benefits of the financial services revolution. My guess is that most of the major threats that I have summarized will not happen. For these threats to be avoided, however, we will have to make our case to both those who are potentially most affected and to the wigging wonders of Washington.

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Is Banking Different? A Reexamination of the Case for Regulation

Robert T. Clair, Gerald P. O'Driscoll, Jr., and Kevin J. Yeats

Banks are regulated because they are believed to be special in some way. The ways in which banks are special must distinguish them from ordinary firms, which are subject only to market discipline and the general laws governing all persons and institutions. The rationale for viewing banks as different kinds of institutions has evolved with time. For this and other reasons, the case for regulating banks is seldom spelled out in detail.

Gerald Corrigan is exceptional for clearly making the case for regulating banks. In his now famous essay, "Are Banks Special" Corrigan (1983: 7) adduced three essential characteristics distinguishing banks from other institutions: (1) banks offer transaction accounts; (2) banks are the backup source of liquidity for all other institutions; (3) banks are the transmission belt for monetary policy.

There are grounds for disputing Corrigan's list, just as there were when he first penned the essay. Certainly the passage of time has further eroded any sharp demarcation line between banks and nonbanks. For instance, a host of financial institutions offers various instruments that possess most if not all the characteristics of transaction accounts. And, if banks are the transmission belt for monetary policy, the belt is wearing thinner with time. Nonetheless, Corrigan's approach is not only consistent but authoritative. Accordingly, in this article we utilize Corrigan as a benchmark.

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Corrigan's three characteristics constitute real effects of banking. They represent a kind of positive externality of having evolved a modern commercial banking system. Interpreted this way, his argument is categorical. It deals with the benefits of maintaining and protecting the institution of banking. This latter point is important for purposes of this article because we examine a narrow but nonetheless important issue: the costs of bank failures. We focus on the consequences for the real economy of bank failures and bank closures. Our analysis is necessarily microeconomic. We do not analyze the consequences of any type of systemic banking crisis or failure. In order to bridge the gap between our study and the broader issue of systemic bank failures one needs to examine the issue of contagion effects.

Many have postulated that bank failures are costly because the failure of one bank can lead, in a domino effect, to other bank failures. According to this argument, failure of one bank—especially a large bank—leads people to doubt the safety of other banks. As the argument goes, it is prohibitively costly (or nearly so) for individuals to monitor banks. If the public's faith in banks is shaken by one or a series of bank failures, then it will withdraw funds from the banking system—a classic run. In this scenario, even sound banks are caught up in the process. Banking runs induce banks to scramble for liquid funds by dumping assets at fire-sale prices. The process leads to asset and even price deflation, and, as a consequence, to depressed economic activity.

At one time, the mere utterance of "contagion effects" was enough to dispose of an inquiry into the special nature of banks. Important work by George Kaufman (1990, 1992) and others, however, has cast doubt on the empirical relevance of contagion arguments.

More anecdotally, we offer the evidence from the Texas banking crisis. In that crisis, 590 banks failed between 1981 and 1991. Yet, a recently retired discount window official confirmed that he knew of no examples of contagion during the Texas banking crisis. Depositors withdrew their funds from failing banks, but redeposited them in other banks. Apparently able to distinguish failing from sound banks, depositors did not run on the banking system as a whole.

While we deal with Texas banks in this article, we do not attempt to test systematically the issue of contagion. We limit ourselves to the mundane but important question of the consequences of bank failures and closings. In the final section, we analyze possible public policy implications.

The Gilbert and Kochin Study

Alton Gilbert and Levis Kochin (1989) directly estimated the effect a bank failure/closure has on a local economy. They measured local

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economic performance as retail sales subject to sales tax and nonagricultural employment. Using data from rural counties of Kansas, Nebraska, and Oklahoma, they estimated the effect of bank failures and bank closures independently. Failures and closures were measured using the percentage of assets held by failed or closed banks in the county. This measure allows the magnitude of the failure or closure to be introduced into the estimation. The model also included variables to control for local economic conditions, seasonal effects, and shocks common to all rural counties.

Their results, summarized in Table 1, do not show a great deal of support for the idea that bank failures might affect a local economy. Data were available to conduct ten tests for the effects of bank failures and bank closures. Only one of the five regressions examining bank failures indicated a significant negative effect of bank failures.

TABLE 1

RESULTS OF THE GILBERT-KOCHIN RESEARCH ON MAXIMUM EFFECT OF BANK FAILURES AND CLOSURES IN RURAL COUNTIES

	Failures			Closures		
	Sales	Employment	No.	Sales	Employment	No.
Kansas	NE	NE	24	−6.22%	−2.08%	8
Nebraksa	−3.31%	NE	20	−13.48%	NE	7
Oklahoma	NA	NE	18	NA	−20.21%	6

NE—No significant effect.
NA—Data for estimation not available.

There was evidence that bank closures may have significant negative effects on local economies. In four of the five regressions examining bank closures, there were significant negative effects in the first year following a bank closure. In some cases, however, the results are difficult to interpret. The extremely low number of bank closures may be one of the problems in estimating their effects. As reported in Table 1, there were only 6 bank closures in Oklahoma, 7 closures in Nebraska, and 8 closures in Kansas during the sample period. One of the more extreme results was in rural Nebraska were a bank closure was estimated to have the effect of reducing retail sales by 13.5 percent, but had no significant effect on nonagricultural employment in the same county.

Texas as a Case Study

Texas offers another geographical area that experienced a large number of bank failures. Furthermore, Texas' size and the large number

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of counties provides a large sample to estimate the effects. Texas has 254 counties and 248 of theses counties have at least one bank. During the period under study, 1981 to 1991, a total of 567 Texas banks failed in 133 counties, and 24 banks were closed in 18 counties. The average bank that failed accounted for nearly 14 percent of total banking assets in a county and nearly 23 percent in rural counties. The average bank that was closed accounted for almost 6 percent of total banking assets in the county and over 15 percent in rural counties.

This time period encompasses a wide range of economic performance for Texas. The Texas economy grew rapidly until 1986. By 1986, the decline in oil prices and the collapse of real estate and construction activity as a result of overbuilding pulled Texas into a severe regional recession. By midyear 1987, the state's economy began to recover. Employment growth has been moderate but positive for most of the 1987 to 1992 period. The national recession slowed Texas growth, but Texas did not experience a recession itself.

The financial performance of Texas banks followed a similar roller coaster ride over this time period. Texas began the decade of the 1980s with the most profitable large banks in the nation. Following the collapse of energy and real estate industries, Texas banks failed in numbers not seen since the Great Depression. Financial conditions hit their trough in 1988 when only 23 percent of banking assets of Texas banks were held by healthy Texas banks.[1] Bank failures peaked in 1989 at 134. Texas banks have recovered through a combination of FDIC-assisted mergers and liquidations; unassisted mergers, especially with large out-of-state banks; and through internal contraction and rebuilding of capital. As of the third quarter of 1992, 72 percent of Texas banks are considered healthy. Texas banks are now outperforming the national average and have better asset-quality ratios than banks elsewhere in the nation.

Data and Model

The model of the local economic effects of bank failures and bank closures presented here is a replication of the same techniques used by Gilbert and Kochin. Two different dependent variables are used to measure local economic activity: retail sales subject to state sales tax (S) and employment (EMP).[2] These variables are converted to natural logs.

[1]Healthy banks are defined as banks that had a capital ratio one-half percentage point above the regulatory minimum, a troubled-asset ratio below three percent and earned positive profits in the quarter.

[2]Employment includes all employees covered under the Texas Unemployment Compensation Act, approximately 97 percent of total employment. Excluded from coverage are the self-employed, unpaid family workers, and employees covered by the Railroad Retirement Act.

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In the study, a bank fails when a chartering agency or deposit insurer declares the bank insolvent. Therefore, the timing of a bank failure is determined by regulatory decision and does not necessarily reflect the economic insolvency of the bank. The deposit insurer resolution of the failure determines if the failure is classified as a bank failure or a bank closure. A bank closure occurs when the deposit insurer chooses to payoff insured depositors and the bank ceases operations. Other resolutions were bank failures. The most common resolution was the purchase of the failed bank by another banking organization. Typically, bank failures suggest that the physical presence of a banking office is maintained, but it was impossible to determine if after purchasing a failed bank, the purchasing organization closed the banking office.

The independent variables measuring the effect of bank failure are the lagged values of the assets of failed banks as a percent of total banking assets in the county (*PAFB1* . . . *PAFB8*). A similar measure of the lagged values of assets of closed banks as a percent of total banking assets in the county (*PACB1* . . . *PACB8*) is used to measure the effect of bank closures. Only lagged values of these bank failure and bank closure variables were used to establish the causality of the bank failures and closures on economic activity. If bank failures/closures were included on a simultaneous basis, it would be impossible to determine if the bank failures/closures caused a decline in real economic activity or if a decline in real economic activity caused the bank to fail.

The lag structure was determined empirically. Initially, an eight-quarter lagged structure was used. If the coefficient on the longest lag was not significant at the 5 percent level, then that lag was dropped and the equation was reestimated. This sequential process continued until the coefficient on the last lagged value was significant or until all but one of the lagged variables had been deleted. In each regression, an *F*-test was conducted to determine if collectively the coefficients on the lagged values were different from zero.

To model the trends in local economic conditions, we included lagged values of the dependent variable (*LS1* . . . *LS8*, or *LE1* . . . *LE8*). Without these lagged values, it would be possible that a decline in economic activity following a bank failure/closure would be misinterpreted to suggest that the failure/closure caused the decline when in fact, the economic activity had been declining steadily and may have caused the bank to fail.

Finally, dummy variables were included for seasonal effects (*Q1*, *Q2*, and *Q3*). In addition, the data were adjusted to remove the possible effects of heteroskedasticity. These corrections, identical to

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those used by Gilbert and Kochin, did not change the regression results significantly.

Results

Regressions were estimated for three different geographic groups of counties: rural counties, counties in the six major metropolitan statistical areas (MSAs),[3] and counties in other MSAs. The rural counties group comprised counties outside metropolitan statistical areas, identical with the definition used by Gilbert and Kochin. The reason to examine rural counties separately is based on the premise that these counties are likely to show the greatest local effect of a bank failure because they are most likely to be served by relatively few banks and have an economic base that may be more dependent on obtaining bank financing. We added the tests of the other groupings to see if any effects could be found in urban areas.

The results of our tests indicate that there is little evidence that bank failures/closures negatively affect local economic conditions. The regression results for bank closures are presented in Table 2, and bank failures results are presented in Table 3. Eight lags of the bank failures/closure variables are reported in these tables.[4] Only the coefficients on the bank failures/closures variables are reported. The coefficients for the seasonal dummy variables and the lagged values of the dependent variables were not reported.

In rural counties, there is no evidence that bank failures or closures had any significant negative effects on either employment or retail sales. None of the coefficients on the percentage of assets held by failed or closed banks (*PAFB* or *PACB*) regardless of lag were significantly negative. Furthermore, the results of F-tests indicate that the hypothesis that all the coefficients are insignificantly different from zero cannot be rejected. This is the most direct comparison with the Gilbert-Kochin study, and the results are substantially different.

Bank closures did not significantly affect retail sales. None of the coefficients on PACB were significant at the 5 percent level in the bank closure model using retail sales as the dependent variable.

[3]The six major metropolitan statistical areas include the counties in the following MSAs: Houston, Dallas, Fort Worth/Arlington, San Antonio, Austin, El Paso.

[4]Following the technique of the Gilbert-Kochin study, the number of lags were originally determined by the empirical results. In most cases, however, no lags were significant resulting in dropping the key explanatory variable from the regression. Consequently, in these tables, eight lags were reported, but tests with shorter lags produce no more significant results.

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TABLE 2

REGRESSION RESULTS FOR LOCAL ECONOMIC EFFECTS OF BANK CLOSURES

	Closed Banks					
	Rural		Six Major Metropolitan		Other Metropolitan	
	Sales	Employment	Sales	Employment	Sales	Employment
PACB1	0.000525	−0.000066	−0.035257	−0.003371	0.020185	−0.005341
PACB2	−0.004011	−0.001403	0.014432	−0.000493	−0.009213	−0.006643
PACB3	−0.001556	−0.001267	0.014742	0.001692	−0.000924	0.012641**
PACB4	−0.002084	0.000404	−0.000104	0.002629	0.026221	0.005299
PACB5	0.001369	−0.001525	0.024033	0.002201	−0.021228	0.008215
PACB6	0.002361	−0.000825	0.086774	0.006353	0.009444	−0.014257**
PACB7	−0.000415	−0.000450	−0.026180	0.004944	0.010467	0.004157
PACB8	0.001284	−0.001315	−0.104323	0.002891	−0.007978	0.002916
F-test Combined Effect	0.1548	0.4780	0.7485	0.0371	0.2322	3.5469**
F-test Equation	999999.99**	999999.99**	999999.99**	999999.99**	999999.99**	999999.99**
Cumulative Four-Quarter Effect (%)	−0.03	0.00	0.02	−0.04	0.14	−0.01

**Significant at 5 percent.

TABLE 3

REGRESSION RESULTS FOR LOCAL ECONOMIC EFFECT OF BANK FAILURES

	Failed Banks					
	Rural		Six Major Metropolitan		Other Metropolitan	
	Sales	Employment	Sales	Employment	Sales	Employment
PAFB1	0.000457	−0.000138	−0.001181	−0.000071	0.000010	−0.000249
PAFB2	−0.000855	−0.000046	−0.001655	0.000318	0.004527**	0.000208
PAFB3	0.000150	−0.000216	0.001843**	0.000170	0.001317	−0.000090
PAFB4	−0.000443	−0.000018	−0.000202	0.000315	−0.001378	0.000083
PAFB5	0.000992	0.000018	0.004349**	0.000284	−0.000847	−0.000202
PAFB6	0.000918	0.000071	0.000700	0.000219	0.000949	−0.000131
PAFB7	0.001455	0.000113	−0.002457**	0.000104	−0.001343	0.000124
PAFB8	−0.000228	−0.000027	−0.000283	0.000116	−0.000611	0.000033
F-test Combined Effect	1.2502	0.2787	4.6532**	0.7227	2.2765**	1.3520
F-test Equation	999999.99**	999999.99**	999999.99**	999999.99**	999999.99**	999999.99**
Cumulative Four Quarter Effect (%)	−0.03	0.06	−1.10	0.08	3.47	−0.21

**Significant at 5 percent.

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Furthermore, F-tests failed to reject the joint hypothesis that all the coefficients on the lagged values of percent assets held in closed banks (*PACB*) were equal to zero.

Bank closures had no negative significant effects on employment. In rural counties or major metropolitan counties, there were no significant coefficients. In other metropolitan areas, there were three significant coefficients on *PACB*, but two were of the wrong sign. The estimated effect of an average bank closure on employment in these other metropolitan areas was a 0.01 percent decline one year after the failure. This estimate takes into account the direct effect of the bank closure and the indirect effects a bank closure would have through lagged values of the dependent variables. There were no long-term negative effects on employment.

Bank failures had no significant negative effect on employment. In all three geographic groups, no coefficient on the percentage of assets held by failed banks (*PAFB*) was significant at the 5-percent level. In addition, the joint hypothesis that all the eight coefficients were insignificantly different from zero could not be rejected by an F-test.

Bank failures appear to have little impact on retail sales. In rural counties and in the other metropolitan areas, there were no significantly negative coefficients on *PAFB*. In the major metropolitan areas, three coefficients were significant at the 5-percent level, but two of these were of the wrong sign. The cumulative effect on retail sales of an average bank failure in a major metropolitan area is estimated to be a 1.1-percent decline four quarters after the failure.

To summarize our econometric results, there is no evidence that bank closures cause a decline in local economic activity or employment. There is limited evidence that bank failures might cause a decline in retail sales in the local economy of major urban areas. These declines, however, may not reflect any constrained credit supply.

A further examination of the raw data also appears to support the hypothesis that bank failures have relatively little effect on local economic conditions. Even in the most severe cases of bank failures, a decline in retail sales or employment was far from certain. Ten of the most severe cases of bank failures in Texas during this time period, with severity defined as the highest percentage of banking assets in a county held by the failed bank, were examined. For example, in Lipscomb county in the second quarter of 1986, a bank failed that held 71.9 percent of the banking assets in that county. In the four quarters following the failure, retail sales rose 2.1 percent, but employment declined 18.1 percent. In the ten worst cases, retail sales rose in seven of the ten counties and employment rose in half of the counties following the bank failure.

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Even data from counties suffering from severe bank closures did not show overwhelming evidence of negative effects on local economic conditions. Certainly, these counties should have experienced the most detrimental impact. It was likely that citizens in these counties experienced actual losses on large deposits, and since the banks were closed, there would be direct employment effects of the bank employees being discharged. Despite these expectations, only half of these counties experienced a decline in employment in the year following the bank closure. Two-thirds of these counties did experience a decline in retail sales.

Texas, Bank Failures and the Credit Crunch

The above empirical results may be difficult to reconcile with other research on the credit crunch in Texas done by the authors. In 1989 Robert Clair had argued that a credit crunch was slowing the recovery in Texas, and in 1991 Clair and Yeats linked capital losses experienced by Texas banks to the restricted supply of credit. In more recent work, Bernake and Lown (1991) and Peek and Rosengreen (1992) pointed out that there is evidence of a credit crunch in other parts of the country. The apparent inability or difficulty to find conclusive evidence of local economic deterioration resulting from a bank failure/closure might be seen as proof that there was no credit crunch or that it had no measurable effect. In reality, the shift in the loan supply function is a result of numerous factors and bank failures or closures are not required to generate credit crunches (Clair and Tucker 1993).

The credit crunch in Texas has not stopped economic growth, though it may have slowed it. The Texas economy reached its trough in March of 1987 when employment was 6.5 million. Since that time, employment has risen by 860 thousand to 7.3 million by year–end 1992. During the same time period, total loans at Texas banks fell $34.7 billion, and commercial and industrial loans fell $16.7 billion. That Texas was able to grow at all is testimony to the ability of borrowers in Texas to find alternative sources of funds or to expand their operations without additional credit. It is likely that had lending been expanding with the economy, even greater economic growth might have been achieved.

The causes of the decline in lending are multifaceted. Factors causing loans to decline at Texas banks include the decline in bank capital resulting from loan losses, the decline in creditworthy loan demand, increasing regulatory burden that has raised the cost of extending credit, the attractiveness of investing in alternative assets including government securities, possible bank examiner overreaction,

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the decline in asset-based lending following the shift to a low inflation environment, increasing exposure to lender liability lawsuits raising the cost of making loans, and the Federal Deposit Insurance Corporation's (FDIC) techniques for resolving failed banks.

Of the causes of the credit crunch listed above, only the FDIC's techniques for resolving failed banks is directly related to bank failures. In the process of resolving failed banks, the FDIC often created a resolution process allowing the acquiring bank to shift nonperforming and marginal-quality assets to the FDIC or to shift these assets into special collecting or liquidation banks. The purchase and assumption agreements often encouraged banks to classify marginal borrowers as risky and attempt immediate collection of the loans rather than work with the borrowers to repay the loan over time, thus maintaining the lender-borrower relationship. Being placed in a collecting or liquidation bank tarnished the reputations of many borrowers far beyond what might have been deserved. Since it is costly for other lenders to distinguish good credit risks from bad credit risks, a borrower whose loan was placed in a collecting bank tended to be categorized as a high risk and not creditworthy.

Most of the causes of the credit crunch are only indirectly related to bank failures. For example, bank capital reduced by loan losses occurred at both failed banks and banks that survived during this era. Stricter bank examinations, regulatory burden, and lender liability exposure increased for all banks. Consequently, it is possible that the FDIC resolution effect is a minor cause of the credit crunch and bank failures therefore do not have a measurable effect on local economic conditions.

More research should be done to explore the independent effect of lending and bank failures on the local economy. We anticipate future research that will include a measure of lending introduced into the above equations on a lagged basis to determine if there is a direct link between lending activity and local economic conditions while controlling for bank failures, and conversely to determine if bank failures have an effect on local economic conditions independent of lending activity.

Policy Implications

Taken together with the earlier findings of Gilbert and Kochin (1989), our study casts doubt on the linkage between bank failures or closings, and local economic activity. In our study of Texas bank closings, we found at best a weak linkage between failures and employment.

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Our results should not be surprising to economists. Banking is not a particularly labor–intensive activity (and is becoming less so over time), so we would not expect direct employment effects of bank closings to be large. If failed, but not closed, a problem bank should have even less direct effect on local employment.

Analysts have long worried about the indirect employment effects of bank failures. The closure or even failure of a bank disrupts banking and credit relationships. A growing literature puts great importance on the specialized information on local customers possessed by their bankers. By its nature, the information may be lost or at least partially destroyed depending on the method of bank failure resolution. Bank failures could be expected, then, to be accompanied by curtailed lending and depressed economic activity—phenomena now described as a credit crunch. We are not denying that such may be the case, but only asserting that we cannot detect its effects in our study.

We can only speculate about why even the indirect employment effects of bank failures appear to be minimal. First, anecdotal information suggests that bank customers tend to be aware of the condition of banks with whom they have relationships. The very importance of the relationships provides incentives for each party to monitor the other's condition.[5] If the hypothesis is true, then we would expect affected bank customers to make other arrangements (such as securing new credit lines at other financial institutions) as their present bank's condition worsens.[6] To the degree this occurs, the measured effects of a bank failure will be minimal.

This line of reasoning does not deny, indeed it postulates that real resources must be expended when banking relationships are disrupted. The analysis rationalizes, however, why these costs may be sufficiently small that the eventual bank failure has no measurable local economic effects or why these costs are not incurred at the time of the failure or immediately following the failure.

A related explanation points to the wide range of alternative financing available to bank customers. In urban areas, the relevant alternative is frequently other banks. In small towns and rural areas, that option may be unavailable. Trade credit, however, is often relevant and empirically important. Available evidence indicates that trade credit is elastic and tends to be utilized more intensively when traditional

[5]Regulators go to great length to conceal the condition of banks from the public. Given the incentives confronting customers of banks, it is unlikely that regulators could systematically succeed in this endeavor.

[6]This study constitutes an event study: the real effects of bank failures. The hypothesis effectively calls into question the timing of the event. More generally, it suggests that bank failure is not an event but a process.

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lending is disrupted. Again, the existence of an elastic supply of trade credit may mitigate the local effects of bank failures.

None of our reasoning questions the critical role played by banks in highly developed economies. The failure of a single bank, however, does not constitute a breakdown of the banking system. The geographical and temporal scope of the present study is particularly instructive in this regard. Our study encompasses the most serious domestic banking crisis since the Great Depression. It is no exaggeration to say that the Texas banking system was severely crippled. Even so, economic life as we traditionally chronicle it went on. We do not know what threshold level of bank failures might trigger crises in the real economy. We can only conclude that our study adduced no evidence that this level was attained in Texas during its recent banking crisis.

Our study does not directly address the policy debate over the issue of "too big to fail." It does suggest, however, that proponents of the doctrine that some banks are too big to fail may need to reexamine their case. Banks become large by operating in many large markets. Few large banks, however, are dominant in any of these markets. No money center bank of which we know has as large a market share as some of the banks that we examined in our study. It appears to us, then, that the case for too big to fail rests on the contagion argument. That is, the policy problem of large bank failures should not be described in terms of its direct effects. Rather it is the contagion or spread of weakness to other banks that constitutes the problem. As we observed at the beginning, the case for contagion is now suspect.

In conclusion, to the extent that the case for bank regulation rests on the effects of bank failure, that case is undermined by the current study. We find that bank failures and even closings have minimal if any local economic effects.

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Banking Is Different, *Because* It Is Regulated

George Selgin

As a critic of most forms of bank regulation, I am naturally inclined to sympathize with the basic thrust of Robert Clair, Gerald O'Driscoll, and Kevin Yeats's paper, which is that the empirical case for bank regulation is weak. Nevertheless, I cannot claim to be convinced by the evidence the authors offer in support of their case. On the contrary, I find myself unconvinced for two quite different reasons, each of which appears to contradict the other. The first reason is that the paper really does not prove what it purports to prove. The second is that the paper appears to prove too much. In addition to doubting the usefulness of the evidence offered by Clair, O'Driscoll, and Yeats, I also question whether the arguments they are trying to counter are really worthy of any empirical refutation at all.

Banks Must Be "Different" in a Pareto-Relevant Sense

In offering empirical evidence to show that banks are not "different" from other firms, Clair, O'Driscoll, and Yeats unwittingly suggest that, if banks were in fact different in the sense being investigated, then the banks would indeed be in need of regulation. In taking this approach, the authors may be said to grant too much to proponents of regulation, for they fail to note how the "differences" in question would not provide a valid basis for regulation even if the differences' empirical reality were beyond dispute. To see this, it is necessary first to consider for a moment the kinds of "differences" that can justify regulation, and the kinds that cannot.

Obviously, banks are different from other firms in numerous respects that do not offer any special basis for regulating them. In

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order for any particular difference to constitute a basis for regulation, the difference has to be one that points to some likely market failure. Specifically, since we are here concerned with bank failures, the question is whether bank failures may, in an unregulated setting, have some Pareto-relevant external effects that appropriate regulations, e.g., deposit insurance or a lender of last resort, could avoid. The references here to market failure and Pareto-relevant externalities are important, for they suggest that the mere existence of "third party" or "external" effects of bank failures alone need not provide any valid basis for regulation. As long as external effects of bank failures are effects realized indirectly *through* market price signals, they are not Pareto-relevant and do not imply any market failure justifying government intervention.

In the literature, the most important arguments given for regarding bank failures as different in a Pareto-relevant sense are those stressing the potential for individual failures to lead to failure of the entire banking and payments system through panic-based "contagion" effects. Such systemic failure may have Pareto-relevant external consequences because it may lead to a massive contraction of the money stock, which in turn requires a substantial downward adjustment in the general level of prices to preserve aggregate demand-supply equilibrium. The relevant "market failure" that comes into play in this case is the failure of money prices generally to adjust downwards in a timely fashion, avoiding short-run "monetary disequilibrium" and its real side-effects (Yeager 1986). These real side-effects of systemwide bank failures are Pareto-relevant because they occur instead of rather than in consequence of altered market price signals.

Contagion effects of bank failures need not be systemwide in order to be Pareto-relevant. Even limited contagions may have Pareto-relevant consequences, for example, by causing depositors to withdraw funds from otherwise sound institutions despite the absence of changes in bank rates of interest or other price signals. Such limited "confidence"-externalities have been invoked by numerous writers as a basis for regulating banks.[1]

It is, on the other hand, difficult to come up with any non-contagion-based Pareto-relevant external effects arising from a bank failure. To be sure, plenty of non-contagion-based external effects of bank failures have been pointed out; none, however, seem to be Pareto-relevant

[1]Roland Vaubel (1984: 32) observes, however, that limited confidence externalities are only potentially and not necessarily Pareto-relevant: if, for example, bank B's output depends on confidence in bank A, bank B has an incentive to support bank A in the event of a run on the latter. In that case, "the externality is appropriable and not Pareto-relevant."

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in the sense defined above and in Tibor Scitovsky (1954). Thus, a bank failure may result in reduced sales by local firms and reduced local employment, stemming from both reduced local availability of credit and a loss of income to the bank's own former employees. But all such effects are reflected in changes in supply and demand and, ultimately, in changed price signals. None of them is, therefore, symptomatic of any definite market failure. Whether such external effects are great or small is, therefore, quite beside the really crucial point, which is that, regardless of their magnitude, the effects can never justify viewing banks as different in any policy-relevant respect.

Yet the evidence accumulated by Clair, O'Driscoll, and Yeat's refers precisely and solely to such local, noncontagion-related consequences of bank failures. The evidence is supposed to show that such effects are small if not nonexistent, and that banks therefore are not different in this particular respect. To this one is justified in replying, "so what?", for the fact is that the existence of such effects could not possibly justify regulating banks anyway.

The Paper Does Not Prove Anything

Let us put aside now the question whether local effects of bank failures are Pareto-relevant, to consider instead Clair, O'Driscoll's, and Yeats's claim that such effects are empirically small or insignificant. Is their claim convincing? In my view, it is not, because the evidence they offer to support it fails to allow for a possible connection between the direct and indirect (contagion-effects-based) consequences of bank failures. So long as contagion effects are admitted to be possible in an unregulated banking system, the mere absence of adverse direct local effects of bank failures in a regulated system cannot be taken as proof that the adverse direct effects of bank failures would be insignificant *in the absence of regulations.*

The authors do not themselves attempt to address the contagion effects argument. They do, however, cite literature that is critical of the contagion effect claim. The findings of this literature must be interpreted with caution: what the literature shows is that, prior to the New Deal, systemic contagions were rare, and that, since the New Deal, there have been no systemic contagions at all. Evidence of limited contagions, on the other hand, has been observed since the New Deal, though such contagions have been less severe and less frequent than limited contagions observed prior to the New Deal. Thus, George Kaufman (1993) cites numerous studies showing evidence of secondary (limited) but not primary (systemic) contagion. These empirical findings by themselves do not support the conclusion

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that limited contagion effects are no longer an issue. They also leave open the question of whether New Deal regulations reduced the frequency of both limited and unlimited contagions. It so happens, though, that the authors' conclusions will not generally be valid unless it can be assumed that contagion effects have been *entirely* absent from banking in Texas and that such effects would have been absent even *without special government regulations*. Although Clair, O'Driscoll, and Yeats acknowledge that their paper does not directly address the contagion effect argument, they do not seem to realize that even their more modest claim of showing that bank failures do not have significant direct (as opposed to contagion-related) local effects on real activity become dubious once the contagion argument is taken seriously.

To see why, assume that there are two kinds of banks: "bad" banks, which have been making uneconomical loans and are bound to fail because of this; and "good" banks, which invest wisely but may fail nevertheless if bad bank failures are accompanied by contagion effects. Now, it is not at all counterintuitive to think that bad bank failures have no direct negative local economic effects, or that such failures may even be directly beneficial in so far as they are followed by a more economical use of resources. On the other hand, good bank failures due to contagion effects might be expected to have direct negative effects (and certainly would not be expected to be beneficial), since a presumption exists that good banks could not be good if they were not making their customers better off: it is, after all, a first-principle of economics that free exchange makes both parties better off ex ante, and that, when such exchange is consistently profitable to a firm, it is almost certainly profitable to most of the firm's customers.

Considered in light of the above framework (which allows for the possibility of limited if not systemic contagion effects) the evidence offered by the authors fails to contradict the argument that banks are in need of regulation to avoid large local effects from bank failures. The evidence fails because it is taken from a regulated system, and therefore cannot tell us what local effects bank failures would have in the absence of regulation. Thus, if one believes (as proponents of regulation presumably do) that regulations do in fact succeed in avoiding contagion effects, then one would infer that the evidence consists of data for bad bank failures only: in the absence of benign regulations, good banks might also occasionally fail, perhaps causing serious harm to their communities. Thus, one would conclude that, far from showing the lack of any need for regulation, the evidence offered by Clair, O'Driscoll, and Yeats actually proves that regulation is needed and that it has been working quite well.

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Even if some (perhaps limited) contagion effects continued to be present despite regulation, the evidence would still fail because it would jumble-together the effects of good and bad bank failures. That is, although some good banks might be failing and their failures might damage their local economies, this damage might not be revealed by the regression results because the damage might be offset by a larger number of insignificant or even positive effects from bad bank failures. Thus, for example, suppose that bad bank failures in Midland County at the end of 1983, which by themselves may have been beneficial to Midland's economy, triggered harmful failures of good banks in Gaines County at the beginning of 1984. The overall results appear to be a wash. But the implication of the story is that regulation has a positive role to play in reducing spillover effects. Indeed, the story may suggest a need for more aggressive regulation to further reduce such effects.

Of the two potential avenues for failure noted above, the former is probably the most relevant in so far as there does not appear to be any evidence at all of contagion effects in connection with Texas bank failures during the last two decades. The general point remains valid nonetheless, namely, that it is not possible to overlook a *potential* role for contagion effects in assessing the purely "direct" local effects of bank failures: what observed local effects signify will depend on whether contagion effects are also present or not. More importantly, observed local effects may reflect the influence of the regulatory regime, and might change were the regime to change. In this particular case, bank regulations may play a part in minimizing the adverse local effects of bank failures. One cannot, therefore, legitimately point to the absence of adverse local effects as undermining the case for particular regulations, such as deposit insurance.

Many will recognize the above argument as a kind of "Lucas critique" applied to the empirical appraisal of banking (as opposed to macroeconomic) policy. It is both natural and proper to wonder, in response to such a critique, whether empirical evidence of any sort could serve as proof against conventional arguments for regulating banks. The answer, I think, is that empirical evidence can prove that conventional arguments are wrong, but that such evidence must be of a sort that cuts across diverse regulatory regimes, including ones where specific forms of regulation are entirely absent.

The Paper Proves Too Much

My final criticism of the paper, which seems to contradict the previous criticism, is that, in so far as it may appear to prove anything at all, it proves too much. For in showing that bank failures are not

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harmful, the authors in effect suggest that we need not worry about policies that may make banks more failure-prone. Since the paper refers to Texas banking in particular, it may tempt certain readers to conclude, for example, that past anti-branching laws were not such a bad thing, or that no one ought to regret Texas banks' heavy involvement in the oil boom of the late 1970s. Of course, such conclusions sound ludicrous, and the authors would certainly reject them. Nevertheless, the fact is that the evidence reported by Clair, O'Driscoll, and Yeats appears to support such ludicrous claims. To put the matter another way, in their zeal to show that banks are not different in any sense justifying regulation, what the authors have succeeded in showing instead is that regulation (in Texas at least) has been quite irrelevant: their findings suggest a kind of regulatory neutrality doctrine for banking akin to the monetary neutrality doctrine of the New Classical economists.

Ironically, O'Driscoll himself has criticized New Classical arguments, originally devised to counter Keynesian arguments for monetary fine-tuning, for appearing to suggest that all monetary policies and regimes are equally ineffective (O'Driscoll 1984: 11). Such a stance overlooks, O'Driscoll has observed, that different regimes may have broadly different implications for both theory and real economic activity.

Reconciliation of the Criticisms

Since I may appear to have offered two contradictory criticisms of Clair, O'Driscoll, and Yeats, I should now attempt to reconcile them. I argued that the authors' conclusions may understate the beneficial effects of regulation, by failing to acknowledge a possible role for regulation in reducing contagion effects. On the other hand, I also suggested that the authors may have downplayed the adverse effects of regulation, by conveying the impression that bank failures (and, by implication, regulations that contribute to bank failures) are entirely innocuous. How can such apparently opposite criticisms be reconciled? First of all, it is entirely conceivable that certain regulations increase the number of bank failures while others reduce the extent of contagion effects arising from such failures. Indeed, some regulations might do both, and still others might actually be seen as a *source* of contagion effects were it not for regulations having the opposite effect. These potential consequences of regulation must first be untangled from those of banking *per se* before anything conclusive can be said about just how different banking is from other industries.

I personally suspect that such an untangling would lead to a conclusion different from both the conventional view of banking and the

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view defended by Clair, O'Driscoll, and Yeats. The conventional view is that banking is different, and therefore in need of regulation. The authors' view is that banking is not different, and therefore is not in need of regulation. The truth, I suspect, is that banking is indeed different, but that it is different only *because* it has been (badly) regulated.

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Regulatory Restructuring: Resolving the Fed's Conflicting Roles

Catherine England

Regulatory restructuring has surfaced again in political and academic debates in and around Washington. This is not a new topic. Proposals for a more efficient, a more responsive, or just a different regulatory system have been around at least since the late 1930s. The most recent restructuring proposal was offered by the Clinton administration in March 1994. As of April 1994, this proposal seems to be stalled in Congress in large part because of opposition from the Federal Reserve System.

Most restructuring proposals are motivated by the desire to streamline or consolidate the bank regulatory structure.[1] The Clinton administration's proposal is offered as part of its initiative to reinvent government, for example. Others support regulatory restructuring because of the perceived need to address inequities in cases where institutions offering similar services are regulated differently. My interest in the topic has grown from other concerns. First, regulatory restructuring could be a path to creating a regulatory system that is more responsive to changing market conditions. Second, regulatory restructuring could establish the basis for demonstrating the superiority of financial systems marked by less government involvement. Finally, regulatory restructuring could offer a means for dealing with the increasing role forbearance and the "too big to fail" doctrine have played in bank regulatory policies.

Whatever the reasons for considering regulatory restructuring, it also provides a useful context within which to discuss the various roles of the Federal Reserve System. The Fed is not only the nation's

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The author is President of England Economics in Alexandria, Virginia. This paper, which is based on the version presented at the March 1993 Cato Institute Conference, "Financial Deregulation in a Global Economy," has been substantially revised.

[1]In this paper, "banks" and "banking" refer to depository institutions generally unless noted otherwise.

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central bank, it is also the lender of last resort and a bank regulator, and it competes with banks in providing certain services. Many authors have argued that these multiple roles create conflicts of interest. Other observers contend that the Fed must wear many hats to be effective.

The purpose of this paper is thus twofold. First, I suggest a regulatory restructuring plan designed to enhance the advantages of the dual banking system while addressing some of its shortcomings. Then I focus on the role the Federal Reserve should play in a newly structured regulatory system.

My own preference is definitely for less regulation rather than more. In England (1988), I argued that we would be better off today if federal deposit insurance had never been introduced. I am convinced by arguments from George Selgin (1988), Larry White (1989), and Kevin Dowd (1992), for example, that closing the central bank and eliminating industry-specific regulation would lead to a more responsive, more stable financial sector. But as Lee Hoskins (1991: 3) noted:

> It is not sufficient to argue that market-oriented alternatives to our current central banking structures function better in other times and places. . . . This begs the question of why such a system did not prove to be sustainable. Nor is it sufficient to argue that this system would have prevailed if not for government intervention and interference. This line of debate fails to consider whether any political equilibrium exists that would support a market-oriented system in a modern economy.

I assume then that we will continue to have a central bank and government regulation of banking for the foreseeable future. Given those constraints, I focus on the type of regulatory system that would lead to a stable financial sector positioned to support economic growth.

Problems with the Current System

There is fairly widespread agreement about the fundamental shortcomings of the current system. Several sources have outlined the problems with the existing structure. Bernard Shull's (1993: 100) list is typical.

First, there are unnecessary costs created by overlapping responsibility and duplicate effort. A commercial bank may be subject to examination by as many as three different federal or state regulators. Despite the fact that regulators have attempted to divide oversight responsibilities to minimize overlap, it is clearly more costly to maintain several separate federal regulatory agencies than it would be to maintain one agency.

Second, institutions offering similar services may face different regulatory burdens. This is true within the commercial banking industry,

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but it has become even more of a concern as the distinctions between the banking and thrift industries have been blurred. For equity's sake, it is argued, firms offering similar services should be regulated similarly.

Third, multiple regulatory agencies may lead to competition among regulators. This competition for control over depository institutions is often viewed negatively, and it is expected to lead to a "race to the bottom."

Fourth, the existence of multiple agencies may make it difficult for supervisors to coordinate regulatory efforts when they need to do so. The information necessary to get a "complete picture" of the health of a single large bank holding company may be scattered among several agencies. A bank holding company that owns thrifts, nationally-chartered banks, and state-chartered institutions may have its components examined by as many as four different federal supervisors as well as several state regulators.[2] Institutional differences may make it difficult for regulators to work cooperatively on common problems.

Finally, overlapping responsibility may lead to inadequate accountability. When several regulators are responsible for supervising all or part of a depository institution, it is easier to blame someone else for problems that arise.[3]

Many regulatory reform proposals focus on the first and third concerns identified by Shull. These proposals call for consolidating bank regulatory responsibility as a means of reducing regulatory costs and limiting competition among regulators. As a rule, those who see no need for the Fed to continue in a supervisory role favor one federal agency while those who believe that the Fed should continue to regulate some banks or bank holding companies would have two regulatory bodies.[4] Interestingly, in early discussions of bank regulatory restructuring, the Clinton administration's spokesman, Treasury Secretary Lloyd Bentsen (1993: A21), saw no reason for the Fed to continue as a bank regulator. By March, Jerry Knight (1994: F3)

[2]Passage of legislation allowing interstate branching addresses this concern to some extent. A multistate bank holding company that owns both state- and nationally chartered banks will be asked to choose the charter under which it will operate when converting to a single bank with widespread branches. Thus, there will be one primary regulator for the entire banking organization.

[3]The Treasury's (1991) report also argues that more consolidated regulatory responsibility would make it easier for U.S. officials to coordinate regulatory standards here with those being used in other countries. Because I believe there are advantages to competing regulators, I would argue against making it easier for international bodies to coordinate regulation across national boundaries.

[4]In the former group see for example, George Benston (1983) and Paul Horvitz (1983). Shull (1993) is representative of the latter group.

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reported that the administration's suggested reform retained a role for the Federal Reserve in overseeing banks' activities.

In evaluating restructuring proposals, it is important first to distinguish between two types of regulatory costs: the costs to the federal government of operating the agencies and the costs of regulation borne by regulated institutions (and hence the economy). Current restructuring proposals focus on the former rather than the latter. I would suggest that without competition among the regulatory agencies, the latter costs would have been higher than they are. My focus is on the fourth and fifth problems identified by Shull—the need to reduce the regulatory burden by allowing a banking organization to answer to a single regulator and the need to improve accountability among regulators.

A Restructuring Proposal

As long as the government guarantees banks' liabilities, the government must assume some responsibility for supervising banks' operations. There are two broad types of risks associated with bank supervision. On the one hand, regulators might be too lax, allowing private decisionmakers to operate depository institutions with no private capital at risk, for example. On the other hand, supervisors might be too rigid and inflexible. Overly strict regulation that prevents depository institutions from adapting to changing market conditions may be just as dangerous as inadequate supervision.[5] Washington policymakers tend to focus on the first type of risk and ignore the second. A healthy, stable financial sector requires a balance between the risk associated with stagnation and the risk associated with new, untried activities. It is the attempt to balance that tradeoff that drives the specifics of the proposal outlined below.

Competing Supervisory Agencies

The ability of banks to choose among different supervisors can provide an important protection against overly rigid regulation. The dual banking system served the country well as long as there were real differences between the regulation of nationally-chartered and state-chartered banks.[6] In restructuring the regulatory system, I suggest

[5]As a case study in both types of regulatory risk, consider the savings and loan industry. Overly strict regulation got the industry into trouble in the late 1970s, then inattention to the resulting insolvencies made problems worse in the 1980s.

[6]With the introduction of federal deposit insurance, the distinctions between federal and state banking supervision began to disappear (see Butler and Macey 1988). This is not surprising given the federal government assumed the responsibilities associated with deposit insurance. I will return to this issue below.

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we create three autonomous supervisory agencies or groups of agencies.

First, at the federal level the regulatory responsibilities of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) would be combined into a single independent Federal Banking Administration (FBA). This agency would supervise banks and savings and loan associations choosing to operate under a national (or federal) charter.

The second group of regulators would be the state banking authorities. The new interstate branching law will make state-chartered multistate banks subject to regulation by the chartering state (i.e., the state where the bank's headquarters are located).[7] The chartering state will be responsible for overseeing the financial health of the entire banking organization, regardless of where its branches were located.[8] This is similar to the way in which insurance companies are regulated, and an organization such as the Conference of State Bank Supervisors might assume a coordination role similar to that of the National Association of Insurance Commissioners.[9]

A third regulatory organization might be made up of the regional Federal Reserve Banks separated from the Federal Reserve Board. The regional Federal Reserve Banks might even be made a third possible source of charters. The bank examiners and the payment system expertise are at the regional banks, and in this proposal, the Fed's sole focus would be on conducting monetary policy, thus eliminating the need for the current regional banking structure.[10] It is tempting to suggest that the regional Federal Reserve Banks, cut loose from the Federal Reserve Board, would behave like private self-regulatory organizations in their supervision of depository institutions. The regional reserve banks are "owned" by their member institutions,

[7]Under the current system, state-chartered banks are also subject to a federal regulator—either the Federal Reserve System (for member banks) or the FDIC (for nonmember, federally-insured banks). My proposal would eliminate this federal overseer of state-chartered banks.

[8]Branches in "host" states (states other than the chartering states) will still be subject to state consumer protection laws.

[9]State regulation of the insurance industry has shortcomings, but the state-regulated insurance industry suffered from fewer failures during the 1980s than the federally-regulated banking and savings and loan industries.

[10]Input from the regional bank presidents might be missed at the Federal Open Market Committee meetings. But having regional input for the FOMC would hardly seem to justify the current system if the Fed were stripped of its regulatory, discount window, and payment system functions. A requirement that governors of the Federal Reserve represent different regions might be substituted for the current system.

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after all. Their ultimate behavior would no doubt depend on the incentives created by the legislation separating the regional banks from the Federal Reserve Board.

Each supervisory agency would maintain its own deposit insurance fund. The funds would be "pre-capitalized" by dividing the assets of the FDIC (both the Bank Insurance Fund and the Savings Association Insurance Fund) on a pro-rata basis depending on the number and size of depository institutions choosing a particular regulator. To overcome the problems created by inadequate diversification, the state banking authorities might operate a single insurance fund for all state-chartered banks. Similarly, the regional Federal Reserve Banks might operate a single insurance fund. Institutions supervised by a particular agency or group of agencies would be assessed the premiums necessary to keep their fund at a specified level of deposits.

Once the bank supervisors were established, each bank would decide to what supervisory agency it would answer.[11] Bank holding companies that decided not to convert to a single, branched bank would still be required to choose one supervisory agency to oversee both the holding company and all subsidiary depositories. There would thus be one regulator for each banking organization, broadly defined. This would help increase regulatory accountability and reduce the information and coordination costs associated with multiple regulatory agencies.

Banks would choose their regulators based on the regulatory package they offered. Under this proposal, Congress would give broad discretion over regulatory issues to competing supervisors. Each of the independent regulators would establish its own capital requirements, reserve requirements, powers restrictions, and branching and merger guidelines, for example. It is on the basis of these regulatory packages that agencies would compete.

It is easy to imagine a number of possible tradeoffs. One agency might set relatively high capital standards but allow banks to offer a broad range of products and services. Another agency with lower capital requirements might employ more powers restrictions. One agency might require market value accounting while another employed book value standards. The handling of bank failures could vary from regulator to regulator. Finally, one agency might charge risk-based deposit insurance premiums while another agency would not. The basis for preventing this competition from becoming the

[11]Banks would display prominently their choice of supervisor. Some depositors might choose their banks on the basis of who regulates them.

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widely feared race to the bottom would be the deposit insurance arrangements.

There is some debate about the desirability of combining the regulator and the insurer. Thomas Cargill and Thomas Mayer (1992: 96–97) observed that, "Bank regulators, for their own preservation, possess a bias toward expanded bank powers in an environment of declining bank markets." The Treasury Department (1991: XIX-5) viewed that regulatory bias as a source of conflict between the regulatory and insurance functions. Regulators are concerned with promoting the industry's long-term market share, while insurers have a shorter-term focus, bent on protecting the insurance fund.

I believe the tradeoffs inherent in the tension between promotion and insurance can best be harnessed within one agency.[12] By requiring that banks supervised by a particular agency also assume responsibility for the costs of failures of other institutions supervised by the same regulator, bankers would be encouraged to help monitor both their competitors and the activities of their regulator. The least-cost regulatory package would be one that promoted stability among member banks.[13] Banks would benefit from efficient, effective supervision, and bankers would have reason to complain about policies that increased losses to their deposit insurance fund.

Requiring periodic reports that measure the relative performance of competing supervisors would reinforce these incentives. Such reports might include information about the number of bank failures in recent years, the average capital level, or measures of profitability for institutions supervised by competing regulators. Bankers associated with more effective supervisors would thus gain reputational capital.

Finally, I would allow those institutions willing to forgo government guarantees of their deposits to opt out of industry-specific government regulation all together.[14] Such institutions would be required to tell their customers that their liabilities were not insured by the government.

[12]The failures of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation would seem to provide a rather dramatic example of the inability of a single agency to balance the tradeoffs inherent in regulation coupled with insurance. Remember, however, that the Bank Board's ability to adapt regulations to changing market conditions was constrained by Congress. The Bank Board suggested long before 1980 that federally-chartered S&Ls be allowed to offer adjustable rate mortgages, for example, and Congress refused.

[13]One problem created by the dual banking system was that state bank and thrift regulators could change restrictions on state-chartered banks knowing that any losses would be widely spread through the federal deposit insurance system (see Kane 1984: 768–69; and England 1990).

[14]Of all the long-shot suggestions contained in this paper, this is obviously the longest. But as I am making the suggestions, I might as well include my own favorite.

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Uninsured banks would probably initially cater to fairly sophisticated customers who felt able to assess their bank's strength on their own.

The Advantages of Regulatory Competition

Competition is generally favored by economists and policymakers as a means of minimizing the cost to consumers of obtaining a particular good or service. Competition also encourages providers to pay continued attention to the quality of the services they offer. Better quality bank supervision at a lower overall cost would show up in the cost and quality of the services banks offer their own customers. Edward Kane (1991) likened international harmonization efforts among bank regulators to attempts by commercial competitors to establish a cartel. Life is easier for both government regulators and private businessmen when they face less competition. But as a rule, customers in both cases benefit from competitive forces.

Competing regulatory agencies with broad flexibility to adapt their rules to changing conditions would also offer the advantage of increased diversity and innovation in our approach to financial regulation. There is often no single right answer to questions about capital requirements, accounting standards, or powers restrictions, but a single approach applied to an entire industry may be the wrong answer as we saw in the case of the savings and loan associations. Policymakers would not be asked to "bet the industry" by choosing sides in the debate about whether commercial banks would be strengthened or weakened by allowing them to engage in investment banking activities, for example. A more flexible, competitive regulator might allow some or all of its banks to engage in such activities, providing empirical evidence about the impact of allowing banks broader powers. More diversity would protect private financial institutions and the economy from the consequences of regulatory mistakes as well as allowing for the discovery of better ways of supervising financial institutions.

The Role of the Fed

Anna Schwartz (1988) established that across time and across countries, a key ingredient in banking instability has been price instability. She then concluded (1988: 54–55) that:

> The critical condition that will determine the safety and soundness of financial institutions in the future, as it has in the past, is the price level environment in which they operate. . . . Stabilizing the price level will do more for financial stability than reforming deposit insurance or reregulating.

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Despite this, Alfred Broaddus (1993) pointed out that the Federal Reserve has no clear mandate to pursue price-level stability.[15] The Fed is asked to do many things, including lowering unemployment, regulating banks, and running the payment system, in addition to fighting inflation and deflation. I would argue that the central bank's sole focus should be on providing price stability as a necessary ingredient to broader economic stability. This proposal would thus relieve the Fed of its responsibilities in regulating banks, running the payment system, and operating the discount window.[16]

The Discount Window and Bank Supervision

The Federal Reserve System has vigorously and consistently defended its role as a bank regulatory agency and lender of last resort. Marvin Goodfriend and Robert King (1988: 231–32) quoted a 1985 Federal Reserve position paper:

> Central banking responsibilities for financial stability are supported by discount window facilities—historically a key function of a central bank—through which the banking system, and in a crisis, the economy more generally, can be supported. But effective use of that critically important tool of crisis management is itself dependent on intimate familiarity with operations of banks, and to a degree other financial institutions, of the kind that can only be derived from continuing operational supervisory responsibilities.

The Clinton administration's proposal provided the most recent opportunity for the Fed to defend its position as a bank supervisor. Alan Greenspan (1993: A16) insisted that removing the Federal Reserve from "direct, hands-on involvement in supervision and regulation" would have "bad effects on public policy in a number of areas, most especially our ability to anticipate and cope with potential systemic financial problems."

Operation of the discount window was one of the primary reasons for creating the Federal Reserve. The Fed's first regulation, Regulation A, established the rules under which member banks could borrow funds from the Federal Reserve System. But solvent banks in need

[15]Broaddus (1993: 6) noted that the Federal Reserve was not given a mandate to pursue price level stability in the beginning because, "The clear presumption underlying the Act was that the new central bank would concern itself mainly with making liquidity available on a timely basis to smooth short-term movements in interest rates." The United States was on the gold standard at the time, and the nation's money stock and its price level were governed by the nation's stock of gold.

[16]The version of this paper presented at the conference suggested the Fed continue operating the discount window. I have since been convinced that the discount window is unnecessary to conduct effective monetary policy, and its potential for abuse is not offset by possible benefits (see Goodfriend and King 1988; and Schwartz 1992).

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of borrowed reserves today enjoy a number of choices they did not have in 1913. Further, Goodfriend and King (1988) have demonstrated that the discount window is not necessary to the Fed's conduct of monetary policy. Finally, more than 80 years experience with the Federal Reserve has proven how costly its operation of the discount window can be.

The Federal Reserve does not need the discount window to provide liquidity to the financial system. More neutral open market operations can accomplish that function. The discount window enables the Fed to direct assistance to individual institutions or groups of institutions. It is this use of the discount window to support specific institutions that has alarmed observers in recent years.

Schwartz (1992: 59) reported the results of an inquiry from the House Banking Committee. Between January 1, 1985 and May 10, 1991, 530 banks that borrowed from the Fed's discount window had failed within three years of the onset of their borrowing. Of these 530 failed institutions, 437 had been able to borrow from the Fed despite having been assigned the lowest supervisory rating—CAMEL 5.[17] Sixty percent of these institutions had loans amounting to $8.3 billion outstanding to the Fed at the time of their failure, and $7.9 billion of this total was extended to institutions with CAMEL 5 ratings. In the face of this evidence, it is difficult to believe that the Federal Reserve remains committed to lending only to solvent banks.

The concerns generated by this type of discount window lending are many. In the first place, loans to insolvent institutions are in reality government-sponsored capital infusions. Such discount window advances allow insolvent banks to stay open longer than they otherwise would. The evidence is abundant that delaying a bank's closure generally leads to increased losses as owners and managers use the time to gamble to recoup past losses. Extended discount window loans to troubled institutions also facilitate the "escape" of uninsured depositors from these institutions. This not only increases the cost to the FDIC when the institution is finally closed, it also increases moral hazard by encouraging larger, more sophisticated depositors to seek high returns from unstable institutions in the expectation that they will be able to pull out before banks are closed. The belief that they will be able to borrow for extended periods from the Federal Reserve also encourages less caution and more risk-taking among bank managers.

[17]CAMEL is the acronym for the five measures of bank health considered by examiners: *c*apital adequacy, *a*sset quality, *m*anagement, *e*arnings, and *l*iquidity. A CAMEL 1 institution is considered in good health while a CAMEL 5 institution is viewed as being in eminent danger of failing.

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Further, when weak banks obtain subsidized discount window loans, they gain a competitive advantage over stronger institutions dependent on private debt and equity capital. This further skews incentives toward more risk-taking.

Finally, as long as the discount window remains open it will be subject to political pressures to use it to support favored borrowers. Although this pressure is most apparent where large banks are concerned, it does not end there. Schwartz (1992: 61) reported that from 1934 to 1946, the Federal Reserve Banks made some 3,500 loans amounting to more than $560 million to nonbanking commercial firms "unable to obtain assistance form the usual sources." The Nixon administration urged the Federal Reserve to lend to the Penn Central Railroad in 1970, although the Fed rejected the request. In 1975, some congressmen suggested that the Fed might lend to New York City during its fiscal crisis. More recently, William Seidman asked Congress for a Federal Reserve loan for the FDIC in 1991, and Rep. Joseph Kennedy introduced legislation (H.R. 1257) in the 103rd Congress that would open the Federal Reserve's discount windows to the insurance industry. It is encouraging that the Federal Reserve has resisted the most recent requests to provide funds to nonbank institutions, but past resistance is no guarantee of continued success in the future. Closing the discount window would remove the temptation of Congress to use the Fed as a convenient source of off-budget credit.

In short, solvent banks in need of liquidity should be able to obtain funds from private sources. Improved information technologies, increased financial integration, and now the advent of interstate branching should eliminate the need for discount window loans for healthy institutions. No doubt if the Fed's discount window were closed these sources of funds would be strengthened and/or other sources developed. As Goodfriend and King (1988: 235) concluded:

> As with many other areas of government intervention, the efficacy of discount window lending turns on the relative efficiency of the government and the private sector in undertaking a productive activity. We know of no analyses that document the relative advantage of the Federal Reserve in this area. Plausibly, the private market is superior because it is difficult for the government to lend only to illiquid but not insolvent banks, rather than succumbing to political pressure to support powerful banks.

Operation of the Payment System

The Fed was patterned in part on the more successful 19th-century clearinghouses. The need for a nationwide clearinghouse, or bankers' bank, grew from the fractured nature of the U.S. banking system, but

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even so, it was 1980 before the Fed allowed nonmember banks to have direct access to its payment system.

There is no reason today for the Fed to run the payment system. There are certainly other models available. Angela Redish (1991) pointed out that the Bank of Canada is but one member of the separate Canadian Payments Association. There are also private clearinghouses in operation today.[18] George White (1983) argued that these private organizations would make more efficient payment system choices without the overwhelming influence of the Fed. George Benston (1983) suggested that the Federal Reserve's payment system be reorganized as a private corporation, with member banks' stock in the Fed exchanged for stock in the private payment organization.

A Sampling of Objections

Gerald Corrigan (1991: 10) asserted bluntly that, "The Federal Reserve, as the nation's central bank, must maintain an important role in the bank supervisory process." There are at least three bases for this assertion. The first has to do with judging the solvency of those who apply for lender-of-last-resort assistance. Second, John Kareken (1984) concluded that the Fed is less effective at conducting monetary policy when it is required to put out the fires associated with large numbers of bank failures. In Kareken's view (1984: 429), the Fed's insistence that it must act as a regulator arises from a conviction that the OCC and the FDIC "cannot be expected or trusted to regulate with the objective of keeping the Federal Reserve from having to serve as lender of last resort." Finally, the act of supervising and examining banks is also said to provide the Fed with information about the health of the economy that aids in the conduct of monetary policy.

There are several responses to these arguments. I have already suggested that the Fed close the discount window. The Fed's willingness to lend to insolvent institutions for extended periods of time may, in fact, arise from the conflicts of interest created by the Fed's dual role as regulator and lender of last resort. Because bank failures are often viewed as regulatory shortcomings, the Fed is often on the side of hoping that troubled banks will recover. If they do not, the FDIC, not the Fed, picks up the tab.[19] Furthermore, the other regulators

[18]Many of these private clearinghouses serve regional markets, and they often compete directly with Fedwire for business. The largest of these private systems is the Clearing House Interbank Payment System (CHIPS), operated by the New York Clearing House Association. CHIPS processes large international payments.

[19]The Federal Deposit Insurance Corporation Improvement Act of 1991 did take some steps to shift a small part of the cost of delayed closures back to the Fed.

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may also have become dependent on the Fed's willingness to lend to keep troubled banks open. Regulators without the safety net of the discount window might do a better job of regulating from the beginning.

There are also potential conflicts in the Fed's role as regulator and central banker. Stricter capital standards set to go into effect in December 1992 were initially expected to cause a large number of bank failures. Instead, bank profits soared to record levels during 1992, allowing many weak institutions to avoid failure. Robert Vaughn and Edward Hill (1992: C3) observed that,

> The improvement that occurred in bank stock prices—and the ease with which even relatively weak banks can raise new equity—is largely the result of the Fed's decision to lower reserve requirements, the FDIC's decision to bail out sick banks before they become truly insolvent, and falling interest rates which let banks cut their cost of funds even more rapidly than their loan rates. None of these changes the underlying problems facing weak banks.

The impact on the banking industry did raise questions about the Fed's motives in pushing down interest rates in the fall of 1992.[20]

Paul Horvitz (1983: 259) also observed that because both monetary policy and financial regulation often involve political controversy, the Fed must often choose where to concentrate its political power to protect its autonomy. According to Horvitz, its desire to protect its independence in monetary matters has led the Fed to seek to avoid confrontations on "peripheral" issues, including regulatory issues. He thus concluded that, "It is not coincidental that the Federal Reserve has been the most conservative and least innovative of the federal banking agencies."

Finally, controlling the money supply does not require the Fed to regulate banks or set reserve requirements. It merely requires the Fed to know what reserve requirements are. Similarly, there is no reason that the Fed should not have access to any data it wants from the bank supervisors. The German Bundesbank does not regulate banks, it only conducts monetary policy, but banks regularly provide information to the central banker about economic conditions.

In short, Corrigan (1991: 11) got it backwards when he stated, "The stability of the financial system is a prerequisite not only to the conduct of monetary policy but also to the very goals of price stability and economic stability." Price stability and economic stability following from the proper conduct of monetary policy are, instead, prerequisites for the stability of the financial system. As the central bank, the Fed

[20]See Jerry Knight (1992) or "A Central Bankers' Charter," *Economist*, 10 October 1992.

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should create the first line of defense against widespread bank failures by conducting appropriate monetary policy.

Conclusion

There are clearly problems with the current regulatory structure. The system is awkward and often redundant, and it frequently raises questions about who is in charge. Making matters worse, bank failures reached post-war records over the past decade. Current debates first focus on systemic risk and then on how banks and S&Ls should be allowed to adapt to changing market conditions. Meanwhile, progress on the policy front seems slow. It may be that regulatory restructuring can provide a way out of this maze.

Competing regulatory agencies with broad flexibility to adapt their rules to changing conditions would offer the advantage of increased diversity and innovation in financial regulation. A regulator whose policies led to excessive bank failures would lose market share. Meanwhile, private banking institutions would have an alternative when they disagreed strongly with the policies of their supervisor. The ability to opt out of the system altogether would further enhance the choices facing both banks and the economy.

It is also time to reexamine the role of the Fed in the bank regulatory process. The Fed's most important contribution to financial stability is proper conduct of monetary policy. By removing the Fed from bank supervision and by closing the discount window, the Fed would be freed to focus its attention on monetary policy. The Fed has protested that its role in bank supervision is essential to avoiding systemic risk. Schwartz (1992: 66) concluded that:

> If fear of contagion is a lesson the Federal Reserve has learned from the banking panics of 1930–33, it is the wrong lesson. Contagion then occurred in an environment in which the Fed permitted the money supply to decline drastically, rendering banks insolvent not because of their own actions but simply because of the collapsing economy. The right lesson is that contagion need not arise if open market purchases are made adequate both to reassure the market and to prevent a collapse in the quantity of money.

Clarifying the Fed's role is thus the most important contribution to future bank stability.

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The Fed's Dual Role and Regulatory Restructuring

Gary H. Stern

Catherine England's paper proposes an alternative model of bank regulatory responsibilities, but it is not clear from the paper what is broken that needs to be fixed or that the proposed solutions address whatever is broken. Moreover, the paper does not go into detail about the Federal Reserve's role as a provider of payments services, although considerable concern has been expressed from time to time about the potential conflict between this role and its role as a bank regulator. Thus, rather than focusing narrowly on England's paper, let me make several general points that I believe are germane to the discussion.

A Competitive Provider of Payment Services

The first point I would like to make is that, since 1980, the Fed has had to meet a market test in order to remain in various payment services, and it has done so. As a consequence of the Monetary Control Act of 1980, the Federal Reserve provides payments services—check processing, electronic funds transfer, automated clearinghouse, and cash and securities services—with the obligation that costs are covered by revenues, where costs include the "private sector adjustment factor" (PSAF). By definition, the PSAF includes estimates of return on capital, taxes, and so on, that private firms in the business would encounter. Much has been written about the Fed's role in payments, some of it by members of the Federal Reserve Bank of Minneapolis (Fernelius and Fettig 1992). Since the Fed is subject to a market test, there would seem to be no serious misallocation of resources as a result of the Fed's provision of payment services. Thus, it is unclear to me why England asserts that the Federal Reserve should unilaterally

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exit the business. There is, of course, the potential conflict alluded to earlier—the Fed's dual role as regulator and market participant—but the Federal Reserve has been scrupulous about the "chinese wall" between policy and operating areas and, importantly, there has been extensive congressional oversight of the situation.

Benefits of the Fed's Dual Role

A second and related point is that the dual role of the Fed as regulator and service provider has been of considerable value. This is true in a narrow sense, in that operational and payments system risk regulations are better when they come from an organization, such as the Federal Reserve, with hands-on experience in payments. The observation is also true in a broader sense because that first-hand experience and expertise in both roles has served the financial system and the economy well, especially during times of distress or crisis. With regard to recent experience, I am thinking specifically of some of the banking problems in New England of a few years ago and the difficulties with state-insured institutions in Ohio.

In asserting the value of the Fed's dual role as participant and regulator, I recognize that I may sound more than a little self-serving and perhaps parochial as well. This concern brings me to the theme of England's paper: restructuring the federal bank regulatory agencies. Again, I have only a few observations to offer.

From Regulatory Restructuring to Market Discipline

As far as I can see, the principal reason for regulatory restructuring should be to improve the effectiveness and quality of bank supervision and regulation, but not necessarily the efficiency or flexibility. Bank supervision and regulation can surely stand to be improved, but, in my view, regulatory restructuring is not likely to achieve that.

What is needed in bank supervision and regulation, in my judgment, is more market discipline, a message perhaps you did not expect from a Federal Reserve official. Recognize, however, that I speak only for myself on this, as well as other matters. At the Fed we have argued long and written extensively in favor of a form of coinsurance as the vehicle to bring the necessary degree of market discipline to banking. Thus, what I am about to offer is hardly new.

Federal deposit insurance, especially as it has evolved in recent years, creates a "moral hazard" problem. Insured depositors have little incentive to pay attention to the caliber of the banking institutions with which they do business. As a consequence, risk-taking in banking

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is priced too low. Therefore, too much risk is taken on, leading to the now-familiar problems. More stringent supervision and regulation is one response to moral hazard, but I question its effectiveness, no matter how intense or intrusive. Moreover, supervision and regulation are not free—real resources are used in the process.

Coinsurance, on the other hand, would enhance market discipline in banking. By exposing depositors to some degree of risk, it would provide an incentive for them to pay attention to the caliber of their banking institutions. Coinsurance can be designed in several ways. To illustrate, say customers could be limited to one account, fully insured up to $100,000, and anything over that amount would be exposed to risk of loss of, say, 10 percent of the uninsured balance. At this stage, these numbers are just suggestions, since we do not know precisely how well coinsurance would work, and we may want to experiment and gain experience.

In closing, let me add two additional comments about the coinsurance proposal. Not only is it a method for enhancing market discipline and dealing with moral hazard, but coinsurance also has the potential to deal with the difficult issue of "too big to fail." Why? Since coinsurance limits depositor exposure, it also limits the size of the potential spillover effects of financial "accidents." Hence, banks of any size can, in theory, be treated equally. Secondly, coinsurance could end the debate about applying market value accounting to banking. With the proper incentives, depositors can be counted on to use all available information and make whatever judgments and estimates they feel are of value to assess the condition of their bank. They will thus use market value measures, or approximations thereof, if they believe them to be valuable.

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Market Value Accounting: A Guide for Safe and Sound Banking?

Sherrill Shaffer

In recent years, market value accounting (MVA) has generated a great deal of controversy within the banking community. Public statements on the topic have typically reflected a high degree of polarization, with most bankers and some regulators staunchly opposed to MVA but various other experts strongly favoring it.

And yet, if one looks beyond the headlines to the fine print, it appears that the underlying goals of the two camps are not dissimilar. No one wants to destroy value or cripple the banking industry; everyone (apart, perhaps, from a few special cases of vested interest) favors the disclosure of accurate, cost-effective financial information that is useful in making constructive and responsible regulatory and managerial decisions. The disagreement lies in how to attain this goal.

Advocates of MVA point to shortcomings in the current approach, historical cost accounting (HCA): its inability to reflect changing economic conditions of an individual borrower or of the market as a whole, its obfuscation of the proper time to close a failing institution, and its tendency to encourage "gains trading" and other irrational and destructive managerial behavior. Increased competition, a heavy regulatory burden, the high cost of deposit insurance, and the complexity of the modern banking business lend urgency to this issue.

Opponents counter by reciting objections to MVA: its subjective nature for many bank loans, its misleading conclusions when applied to only part of the balance sheet or to "fire sale" prices, its costly potential for increasing the volatility of reported net worth, and its high cost of implementation. The conflict is further complicated by the lack of a single, precise, universally accepted definition of MVA.

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A major focus of this article is whether voluntary implementation of MVA in banking could be likely to create the conditions for improved safety and soundness. This question arises for several reasons. First, voluntary implementation, if sufficiently prompt, could potentially preempt more rigid regulatory requirements, allowing individual banks greater flexibility in choosing an approach better tailored to their own situations. Second, voluntary implementation could perhaps be designed in such a way as to avoid some of the pitfalls that have plagued several versions of MVA as proposed; for instance, we might consider whether banks could choose to mark the entire bank to market and thereby circumvent the distortions of applying MVA to only part of the balance sheet. Finally, record earnings for the banking industry in 1992 make the present time especially propitious for considering such a transition, given that any change from the status quo is likely to entail some startup costs that could reduce retained surplus.

A parallel premise of the article is that the most constructive feasible outcome may be facilitated by reversing the usual analysis. Rather than working forward from a particular definition of MVA and trying in procrustean fashion to force the world into that definition, why not first try to identify a consensus view of an ideal financial reporting system, and then consider what elements of MVA, HCA, or other mechanisms could come closest to achieving a cost-effective implementation of such a system that is useful to owners, managers, and regulators? This approach could help defuse the emotional rhetoric surrounding the issue, facilitate cooperative rather than adversarial use of the best thinking on both sides, and lead to a safer and sounder banking system in the end. In principle, one can decide later whether the outcome is labelled MVA, HCA, or a hybrid—if anyone still cares.

Driving both questions is the fact that movement toward some form of MVA for banking appears inevitable and has been under way for some time. Federal banking regulators have long required banks to designate a separate trading account for those securities they do not intend to hold to maturity and to mark such securities to market; these requirements were extended in early 1992 to loans and securities "held for sale" and to mortgage-backed securities, zero-coupon bonds, and the like (see Shaffer 1992a). The FDIC Improvement Act of 1991 (FDICIA) requires regulators to develop some method of supplemental reporting of banks' market value. The Financial Standards Accounting Board (FASB) has adopted some requirements for MVA and is contemplating broader ones. Thus, events are overtaking the debate, and the practical issue is evolving from "MVA vs. HCA" to "what flavor MVA?" These developments make it imperative to

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achieve constructive consensus on the issue, and provide an even stronger motive for the banking industry to take the initiative in structuring its own accounting reform.

Aspects of a Useful Approach

Part of the controversy involves the conceptual role of an accounting system, with some opponents of MVA arguing that accounting was never intended to serve as a guide to managerial or regulatory decisions. Two brief comments are in order here.

First, financial information is costly to compile and convey, and therefore any individual piece of information must be beneficial to at least some of its recipients before its release can be cost-justified. If an accounting system is worth designing and implementing at all, it must take a form that is useful to managers, owners, or regulators—and preferably all three. Where there is a conflict among the interests of the three groups, we might expect to see banks adopt an accounting system that is favored by the dominant group. Second, as a matter of practice, owners and regulators do in fact assimilate accounting data into their overall view of an organization and their actions toward it. This reality needs to be kept in mind when designing an accounting system. What, therefore, are the informational needs of these various groups, and how will available information be used?

Bank Owners

Bank owners and managers share many common goals, even in institutions where the owners and managers are for the most part different individuals. They need information to make strategic and tactical choices that are profitable for the bank, particularly in the current environment of a sluggish economy, encroaching foreign and nonbank competitors, and stiffer regulatory requirements as exemplified by FDICIA. Some of them also need information capable of winning the confidence of other investors to raise new capital required under the multinational Basle Accord on Risk-Based Capital.

Net Present Value. Subject to regulatory constraints, owners and managers benefit from any decision that enhances current or future bank profits on net. Put differently, the standard that will determine the long-run financial impact of a decision on the owners and managers is its effect on the bank's expected net present value (ENPV).

This bare conclusion must be modified slightly when owners or managers are risk-averse and a given action has a range of possible outcomes that cannot be completely hedged or diversified away. Capital markets do in fact discount stock prices to reflect such "systematic risk." However, as such discounting illustrates, most uncertainty is a

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potentially quantifiable second-order effect while ENPV describes the primary effect. Moreover, analysis of uncertainty must start with the same information needed to impute ENPV, so risk aversion does not alter the preferred accounting system in that respect, even though it may require some extra data or imply somewhat different managerial choices. When comparing MVA and HCA, therefore, it is useful to consider ENPV as a benchmark, even if additional considerations must be brought to bear at some later stage.

An intrinsic link between ENPV and MVA arises because, in an idealized world of perfectly competitive markets, perfect information, and risk-neutral buyers and sellers, the selling price would coincide with the ENPV of the asset or portfolio (Shaffer 1992a, 1992b). Otherwise, an investor could buy or sell the asset and profit from the difference between its price and its present value. Of course, most markets are not ideal, so observed prices may not always correspond to ENPV. Therefore, whenever HCA and MVA give different answers, it becomes necessary to ask which measure more closely approximates ENPV.

If the ENPV of each individual asset and liability were known, the whole bank's ENPV would be known as well. However, it is usually easier to think about ENPV and financial decisions in terms of an individual asset. For example, suppose that a bank has among its assets a security originally worth $100. Now suppose that interest rates fall, so that the security could be sold for $105, reflecting the fact that future income is discounted less when interest rates are lower. Should the bank sell and lock in the gain? Or should it continue to hold the security in hopes that interest rates may fall farther, increasing the potential gain? If it sells, what will be the impact on its portfolio liquidity and on its duration gap, affecting its exposure to interest-rate risk? Will the bank be left with all long-term and illiquid loans? And does the security act as a hedge against declines in the ENPV of some other asset held by the bank? These latter considerations may outweigh the immediate incentive to sell; therefore, an ideal set of information to owners and managers would allow them to examine these various tradeoffs.

By contrast, an accounting system that omits or blurs such distinctions could tend to encourage an immediate sale even if it is not truly in the bank's interest. Under HCA, the security's increase in value will not appear on the bank's books unless the security is sold; if investors evaluate the performance of bank management primarily according to historical accounting statements, management would always have an incentive to sell the security. Such sales are termed "gains trading" and, despite being discouraged by regulators, were

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common among savings and loan associations in the 1980s (O'Brien 1991) and appear to have affected commercial banks as well (Atkinson 1992; Carey 1992).

In this simple example with liquid securities at least, MVA could correct the incentive problem, leading in the long run to the expectation of a higher market value of the bank (Benston 1989). This effect would benefit owners, leading them to prefer MVA in such cases, as well as reinforcing safety and soundness by encouraging actions that improve the bank's long-run net worth. For these reasons, even some bankers strongly opposed to regulatory use of MVA recognize that "mark-to-market portfolio assessment can be a valuable internal management tool" (O'Brien 1991: 7).

It should be noted that ENPV, properly measured, will not suffer from the distortion of "fire sale" losses or liquidation value that plagues some versions of MVA. Even among market prices, there may be a distinction between the price attainable in a quick, forced sale versus that attainable over a longer period of time. Thus, the legitimate concern over liquidation value need not imply a blanket condemnation of MVA, but rather suggests that care is needed in the proper implementation of any accounting system. For instance, in valuing the mortgage portfolio of a large bank, one might want to observe market prices for similar assets, rather than trying to estimate what the particular bundle could be sold for within a short deadline. Indeed, the FDIC, when it must liquidate a bank, usually sells off the assets slowly enough to receive favorable prices, rather than attempting to sell them all at once.

Agency Problems. Even where an imperfect accounting system does not systematically distort managers' incentives, it may at least permit managers to pursue their own objectives at the expense of owners. For example, owners may want to maximize profits by cutting costs, whereas managers may prefer luxury offices and large staffs, hallmarks of "expense preference" behavior. Indeed, Mark Carey (1992) presents some very preliminary evidence that the sort of gains trading discussed above may constitute a form of expense preference behavior among banks that varies with the degree of control shareholders are able to exert over management. To the extent that managers have access to inside information not readily available to owners, managers enjoy some leeway to take actions that could undermine profits. Economists call this situation an "agency problem," a term deriving from the fact that owners hire managers as agents to act on their behalf (Mester 1989).[1]

[1]Evidence of expense preference behavior by banks is mixed. Studies by Franklin Edwards (1977), Timothy Hannan (1979), and Hannan and Ferdinand Mavinga (1980) conclude

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Whenever an agency problem exists, an important question for public policy is whether the actions at stake merely generate pure transfers from one group to another (for example, from owners to managers) or in addition create inefficiencies such that everyone could be made better off under alternative actions. Society as a whole should care about the latter problem but may or may not care about the former.

It is sometimes difficult to distinguish between inefficiency and pure transfers. For example, although economists usually associate expense preference behavior with deadweight losses, such behavior could also directly benefit a bank's employees and other businesses that provide services to the bank. Some such groups, in addition to managers, would therefore be harmed in the short run by eliminating the inefficiency, even if the overutilized resources could be more productively redirected elsewhere in the long run.

Most forms of agency problems tend to undermine safety and soundness, so that regulators' and owners' preferences would be aligned on this issue. However, there is also a possibility that some managers might be more risk-averse than owners and, given the cloak of an imperfect accounting system, could operate the bank more conservatively than owners would otherwise allow them to do. In such instances regulators would tend to be more aligned with managers.

Ideally, competition in the labor market for managers and in the market for corporate takeovers would minimize agency problems (Grossman and Hart 1981; Schleifer and Vishny 1986). But, in practice, if managerial talent is scarce relative to the number of banks, then the best CEOs may be able to command premiums that could involve (or may appear indistinguishable from) expense preference behavior as well as other actions detrimental to shareholders. Moreover, the mandatory legal separation between banking and commerce constrains the corporate takeover market for banks in the United States, since no nonfinancial firm can enter the bidding; and prohibitions against interstate branching limit the number of banks that can vie for another bank. Market mechanisms may therefore work poorly as a way of solving the agency problem in the U.S. banking industry.

All else equal, owners would prefer an accounting system that provides them with the sort of information they could use to verify

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that such behavior exists, while later studies such as by Michael Smirlock and William Marshall (1983) call into question the earlier methods and results. In any case, not all agency problems would necessarily show up as expense preference behavior. Evidence of more general agency problems in banking is presented by Randolph Beatty et al. (1987), Linda Allen and A. Sinan Cebenoyan (1991), John Boyd and Stanley Graham (1991), and Gary Gorton and Richard Rosen (1992). Loretta Mester (1991) likewise finds evidence of agency problems among savings and loan associations.

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that managers were running the bank efficiently. Accounting data, even if imperfect, have always constituted a major source of financial information to owners. There is some evidence that bank owners tend to evaluate bank managers on the basis of such publicly reported data even when it deviates from the ideal. For instance, Greg Clinch and Joseph Magliolo (1991) find compensation of bank CEOs to be positively related to a bank's income from certain discretionary transactions that appear beneficial under current (historical) accounting standards but possibly not in terms of the bank's ENPV (and hence its long-run stock price).

The existence of such a pattern points to a need for improving current accounting practices, so that bank owners can better monitor and evaluate the actions of managers; the fact that such a pattern could even be measured suggests that a practical improvement must be technically feasible. Since banks' owners stand to gain from such improvements, they should (by this argument) tend to favor reforms in the direction of ENPV reporting. Banks' managers stand to lose from any such changes as may reduce their opportunities for expense preference behavior, and they therefore might oppose such reforms. Voluntary improvements of the accounting system would then depend on the ability of investors to prevail over the opposing interests of entrenched management. The dearth of voluntary reform to date might suggest that the banking industry suffers from substantial agency problems. However, as discussed below, agency problems are not the whole story.

Bank Regulators

Bank regulators also need to know the true financial condition of a bank in order to be able to initiate corrective actions or, if necessary, to close the bank in a timely fashion before losses mount further. Simply put, the regulators need to know the bank's ENPV. Thus, even though regulatory objectives may sometimes differ from the objectives of a bank's shareholders, the informational needs of regulators and owners coincide.

An extension of the previous example will illustrate this point. Suppose that the security originally worth $100 now declines in value to $95, either because interest rates have risen or because the issuer of the bond is perceived to be in greater danger of default. Regulators would need to know this information as part of choosing responsible and socially optimal actions toward the bank. If the bank's accounting system fails to reflect such declines, then a regulator who is constrained by law not to close the bank until the *reported* net worth falls below

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some figure (either zero or, under the new policy of Prompt Corrective Action, 2 percent of assets) may find after closure that the actual value of the bank's assets is substantially less than reported, generating higher losses for the deposit insurance fund.

This type of distortion has at least two costly consequences. First, the aggregate cost of deposit insurance will be elevated, leading to the need for higher deposit insurance premiums (and perhaps more intrusive regulation) for all banks. And second, banks using HCA will have an incentive not to sell assets that have declined in value, even though at times it might be in the true interests of owners and managers to cut their losses by selling before the value declines further. Here again, MVA could solve the problem in this simple case, and banks might be likely to support voluntary adoption of MVA under such circumstances.

However, an additional complication surrounding this aspect of accounting is that managers of banks suffering from unreported declines in asset values would have a natural vested interest in resisting any changes that would lead to the full disclosure of those declines. Likewise, owners may wish to conceal declining net worth from regulators and may therefore prefer HCA to the extent that bank closure policies are based on reported accounting data. This factor could be another reason why some bankers, even if advocating MVA for internal bank use, may oppose it for regulatory use.

Such a stance is myopic: if a bank is truly distressed, a distorted accounting system will not change that fact and, indeed, will tend to encourage suboptimal actions that further worsen the bank's condition. Nevertheless, these considerations suggest one reason why owners, as well as managers, might oppose full financial disclosure, even to the extent feasible.

This impediment to accounting reform will be less severe when banks are more strongly capitalized, as they currently are due to a combination of the Basle Accord on Risk-Based Capital and strong profits in 1992. This is another reason why the prospects for voluntary reform look better now than in previous years.

Moreover, it might be possible to coordinate the regulatory closure policy with accounting reform in such a way that owners could become more amenable to such reforms. If a typical failing bank's book value exceeds its ENPV at the time of failure, then applying the current 2-percent closure rule to ENPV would unambiguously tighten the regulatory closure policy on average. If, on the other hand, accounting reform could be carried out with no such tightening, then owners' objections could be reduced and the issue of voluntary implementation again becomes largely an agency problem between owners and

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managers, assuming managers retain an interest in trying to conceal negative shocks from shareholders.

The Practical

Accounting systems, by nature, apply to individual components of assets, liabilities, capital, and contingent claims. But the overall concern of owners and regulators is really the aggregate bank, whatever the individual components may show. ENPV may be defined in principle for individual components, but such an approach may fail to incorporate important cross-correlations that can to some extent hedge the balance sheet in various ways (Chirinko and Guill 1991), and may also fail to address the important question of charter value. Thus, in moving from the ideal to the practical, it is necessary to bear in mind the aggregate picture—and a practical program is absolutely essential to any form of implementation, whether voluntary or mandatory.

One aggregate proxy can be dismissed at the outset. Economists sometimes argue that the stock price, multiplied by the number of shares outstanding, gives the best estimate of a firm's ENPV (perhaps discounted by some risk premium). But this approach does not work well for banks. Many banks are not actively traded; and even for those that are, the stock price also incorporates any value of mispriced deposit insurance, a federal policy of "too big to fail," the capitalized value of any local monopoly power exercised by the bank, and other regulatory and market distortions. Some of the changes embodied in FDICIA, including a move toward risk-based deposit insurance pricing and new limitations on "too big to fail," reduce such problems for actively traded banks in competitive markets. Nevertheless, the stock price is unlikely to be the best attainable measure of most bank's financial condition from the standpoint of the regulator or society.

In search of a better alternative, a look at the individual components of a bank's operations is useful. Three questions are relevant for each component: first, whether its ENPV can be easily obtained (for example, from an observed price in a liquid market); if not, whether a simple approximation procedure (market-based or not) can get closer to ENPV than book value; and finally, if neither of these conditions holds, then whether the item is a major component of the balance sheet of many banks. For items satisfying either of the first two conditions, some improvement over HCA is possible; if only the last condition holds, then we might prefer the less costly procedure between HCA and MVA; and if none of the three conditions holds, HCA would be the method of choice for the particular item and we could rely on a de minimis argument that this practice would not materially distort the estimate of ENPV across the full balance sheet.

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Liabilities

Some liabilities, such as overnight interbank deposits, are effectively carried at market value already, since their short maturity precludes any substantial difference between market and book value. The choice between MVA and HCA would be purely semantic for such accounts. It has been proposed (e.g., Mengle 1990) that the market value of other liabilities with maturities or repricing intervals less than some period (such as a year) could be similarly regarded as equal to book value, as a working approximation.

Some other liabilities, such as large certificates of deposit, trade on active secondary markets and therefore generate an observable price that constitutes a good index of ENPV. MVA is clearly feasible (and, by the considerations discussed in the previous section, beneficial) for such items.

In other cases, it may be possible to compute ENPV directly from cash flow data (see Shaffer 1992a). Such calculations always require knowledge of an account's payment schedule, its effective maturity or repricing intervals, and the likely path of interest rates over time (see Mengle 1990; Morris and Sellon 1991). Thus, when prices are not observed, ENPV accounting requires more data than HCA—but only data that a well-run bank should be tracking anyway. Indeed, if part of the concern is that HCA conveys too little information, we ought to expect that any improvement would require some amount of additional data.

One of the most difficult issues here is how to assess the effective maturity of a bank's core deposits (essentially, demand deposits plus savings accounts). Although their theoretical maturity is zero since they can be withdrawn on demand, there is evidence that such deposits tend to behave like long maturity accounts under normal economic conditions (Flannery and James 1984). Taking account of rollovers, or the influx of new deposits that offset withdrawals in a given period, one might even argue that the effective maturity is infinite.

What has not been adequately measured is how this effective maturity may respond to sudden adverse financial changes in the bank or in the economy. If a bank deteriorates, even its previously stable core deposits may be quickly withdrawn, plunging the bank into a liquidity crisis. A plethora of factors could contribute to such a shift, including not only bank-specific elements such as asset quality, net worth, and probability of failure, but also the regulatory climate and deposit insurance, both of which are outside the control of any individual bank.

George Benston (1989) has proposed that banks carry as an intangible asset the present value of the difference between the actual interest rate paid on core deposits and the market rate typically needed to

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attract a like amount of funds. This proposal, while conceptually elegant and market-based, nevertheless requires an independent measure of effective maturity and therefore falls short of solving the central problem. Even so, other research has shown that publicly available data can be combined with rough estimates of effective maturity to yield improved estimates of a depository institution's true value (Simonson and Stock 1991).

Possibly a better approach to valuing core deposits is to use data from branch sales. John Mingo (1992) has compiled such estimates separately for branch sales associated with going concerns versus those associated with failed institutions, finding a substantial differential between the two categories that could be used to quantify the effects of a decline in financial condition. Core deposits make up a substantial fraction of the typical bank's balance sheet (Mengle 1990), so any further improvements in their valuation methods remain potentially important.

Assets

Some assets, such as cash and trading securities, are already carried on banks' books at market value. In recent years, the quarterly Call Reports required of all banks also report both book and market value for investment securities. Straightforward imputation of market value is also possible for a few other assets. However, these categories of assets seldom cause banks to fail.

Loans constitute the primary obstacle to successful MVA for banks. As of 1990, loans comprised 61 percent of all insured U.S. bank assets, even after netting out loan loss reserves (FDIC 1990). Nearly 30 percent of these loans are commercial and are especially hard to value accurately.

Because of credit risk, the ENPV of many loans is less than their book value. In some cases, as with LDC debt, loan sales, and securitized assets such as collateralized mortgage obligations, a secondary market exists—the loans are liquid—and we can observe a market price that should be representative of their ENPV. Such cases usually involve some combination of large borrowers or homogeneous risk characteristics of the assets. For assets without an observable market price, an alternative approach is required.

Perhaps the best current idea for the nontraded portion of the loan portfolio is to use the book value of loans net of some combination of loan loss reserves (or allowance for loan losses) and nonperforming loans (that is, loans that are past due or not being paid according to schedule) as an estimate of the ENPV of loans corrected for credit

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risk (see Berger et al. 1991). Adjusting for these factors, which banks already report separately, is a way of valuing the overall loan portfolio without having to look at individual loans.

Federal regulators require all banks to maintain a loan loss reserve (Mengle 1990; Walter 1991). Bank managers add to this reserve each quarter out of current income at levels that are supposed to represent their estimate of future credit losses. In turn, when a loan defaults, that loss is subtracted both from the total loans on the bank's asset statement and from the loan loss reserve.

However, loan loss reserves may not be a good predictor of future loan losses for a given bank, especially since they are set largely at the bank's discretion and are subject to other incentives such as income or tax management goals or conformity to peer group averages (Walter 1991). Among other things, netting the reserves out of reported net worth above some level may encourage a bank to reduce its reserves relative to known risk, especially if the bank has adverse inside information. Under the Basle Accord on Risk-Based Capital, reserves up to a maximum of 1.25 percent of risk-weighted assets may be counted as a component of capital. Banks therefore have some incentive not to reserve above this level; however, they may also have an incentive to increase reserves up to this level if they are in need of additional capital and alternative forms of capital are more costly.

Such behavior not only impairs the accuracy of the regulatory measure of market value but can also directly reduce safety and soundness. Auditors and regulators monitor each bank's loan loss reserve practices to try to contain these incentive problems (Mengle 1990), but this monitoring occurs at intervals longer than those at which a bank is required to file financial reports, and the task is essentially as hard as marking the loans themselves to market.

The amount of nonperforming loans is harder for a bank to manipulate and can be broadly verified by examiners. But nonperforming loan figures are not particularly forward-looking: some delinquent loans are subsequently repaid, while others reflect only the final stages of long-standing problems.

A combination of the two approaches, using both loan loss reserves to embody some forward-looking information and nonperforming loans to reduce the incentive problem, has been shown to forecast future losses and bank failure better than either approach alone (Berger et al. 1991). One simple way of applying this approach is to report loans net of the *maximum* of loan loss reserves or a weighted sum of nonperforming loans. This approach minimizes the distortion in loan loss reserves that can occur between examinations or audits and allows a more accurate measure of capital ratios, which legally

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circumscribe many of the regulators' permissible actions toward the bank. And it avoids the need to estimate the ENPV for each loan individually, a very time-consuming and expensive undertaking that also fails to incorporate cross-portfolio hedging. At a minimum, therefore, this approach—which can be construed as a hybrid between MVA and HCA—may represent an improvement over pure HCA.

Putting It All Together

The foregoing discussion suggests that certain practical steps could improve on HCA in meeting the informational needs of bank owners and regulators. At the same time, however, agency problems may leave bank managers resistant to such improvements, and regulatory closure rules might even turn owners against accurate financial disclosure. Careful attention to the interaction between accounting reforms and closure rules can mitigate shareholders' objections; overcoming the agency problem between owners and managers may then be a key to voluntary accounting reform.

How can such reforms best be implemented, taking account of both the new legal requirements for MVA and the valid objections that have been raised against MVA for banks? And what forms of implementation are likely to have the most appeal to banks, thereby qualifying as likely candidates for any voluntary adoption?

One important aspect of a good approach is to begin supplemental reporting of MVA for certain items now, while retaining HCA for "official" purposes until a large enough part of the portfolio has been successfully marked to market. This is the approach embodied in FDICIA and the FASB statements to date. Properly implemented, it serves the interests of bank owners by giving them a clearer picture of their institution's true financial condition, while avoiding many of the pitfalls associated with alternative approaches.

It also has the advantages of minimizing the disruption of the conversion to MVA, spreading the learning and transition costs over time, avoiding the distorted incentives of marking only part of the portfolio to market, and affording flexibility in the pace and direction of further changes. Another advantage of beginning with supplemental reporting is that it gives bankers and regulators a low-cost, low-risk opportunity to identify and correct any unforeseen snags or distortions to incentives related to the new accounting system.

For the part of a bank's loan portfolio that cannot reliably be marked to market, a hybrid valuation reflecting loan loss reserves and nonperforming loans holds promise as a better approximation of ENPV

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than HCA. Such a method could be adopted when we progress to the stage of using MVA for more official purposes and could largely solve many problems that arise from marking to market only part of the balance sheet. In the meantime, there is an opportunity to refine this approach and make it as practical and accurate as possible.

A program of this sort could move in the right direction without incurring the costs of a more radical change. It could also improve the information available to regulators, both by supplementing the overall examination ratings and by updating the bank's market-value data more frequently than examinations are conducted. Perhaps more important, it could improve the accuracy of reported capital ratios, which limit many of the legally permissible regulatory actions toward banks. If these benefits lead to a lower cost of deposit insurance, bank owners could eventually participate in such savings, both in terms of reduced deposit insurance premium rates and possibly in terms of a more flexible regulatory environment than we have seen emerge over the past couple of years. Again, these factors would favor the voluntary adoption of some form of MVA by banks.

One caveat should be noted for smaller banks. MVA may be more feasible for large banks than for small banks, both technically and financially. Large banks tend to specialize in making large loans to large borrowers. Such loans tend to be liquid and can often be marked to market (see Nakamura 1993). Large banks also tend to have the in-house expertise needed to carry out the requisite calculations for MVA without incurring substantial additional expenses. However, accurate, detailed MVA across the balance sheet may not be feasible for smaller banks. As discussed above, small loans to small borrowers tend to be illiquid and cannot be marked to market with precision because of information about the borrower that only the bank knows. Small banks, moreover, may be less able to afford the fixed cost of establishing and maintaining the data flows and analysis needed to impute market value.

Further, small banks are often closely held, making the agency problem less severe and thereby lessening their need for accounting reform. The net impact of this factor is ambiguous, though, since the lack of a severe agency problem also suggests that any reform beneficial to owners is more likely to be implemented.

Finally, many small banks are not actively traded, reducing the effectiveness of market discipline even with accurate disclosure, and thereby diminishing the likely benefits of accounting reform. Therefore, the prospect of beneficial accounting reform—especially on a voluntary basis—may be somewhat slimmer for small banks than for large banks; but their need for reform is also less urgent.

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Market Value Accounting

Richard L. Measelle

Sherrill Shaffer has written a very interesting and timely paper. I want to place my comments in the context of general-purpose financial reporting. As Shaffer notes, there are many users of financial statements in addition to regulators, in particular, creditors and shareholders, who must make investment decisions and evaluate management. Managers are also users.

Regulators have the power to require additional information over and above what typical third-party users can demand, and have the power to limit, control, or forbid certain activities that other users cannot. Subject to the laws of the land, they can define capital computations and set required amounts as they deem fit. Although bank regulators have some of the same information needs as users in general, they may have a different mission. Further, the issue of market value accounting (MVA) is broader than banks, and I would like to keep my comments general.

Some Background

The MVA issue is not new. Prior to 1938, banks carried their investment portfolios at market value. Further, our current model is not entirely a historical cost model, but rather, a mixed attribute model. For example, trading activities are reported at market value, investments in equity securities are carried at market value or the lower of cost or market value, and assets held for sale are reported at the lower of cost or market value. Some specialized industries use MVA as their basic model, e.g., brokers and dealers in securities, pension plans, and mutual funds.

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The current debate is triggered by a number of interrelated concerns, events, and constituencies:

- The savings and loan crisis and concerns about other segments of the financial services industry;
- Changes in the environment—volatility; deregulation and re-regulation; increase in computing power and speed of communication; explosion of new financial products, services, and activities; and growth in international activities and competition;
- The focus of the government and its agencies—Congress (e.g., the FDIC Improvement Act), the Securities and Exchange Commission (SEC), General Accounting Office (GAO), and bank regulators;
- General concerns about the adequacy, consistency, relevance, and completeness of our current financial reporting model, and the perception of abuses such as gains trading and asset impairment issues.

These developments have led to the involvement of accounting standards setters. In the United States that is, of course, the Financial Accounting Standards Board (FASB), but standards setters all over the world are working on projects on this issue. For example, the International Accounting Standards Committee (IASC) Exposure Draft on financial instruments permits comprehensive MVA for financial instruments as an allowed alternative. My comments here primarily focus on the United States.

FASB Project on Financial Instruments

The FASB is currently addressing financial reporting of financial instruments. The FASB's project is a long-term, multi-part undertaking that could be the most complex project it has ever addressed. It was added to the board's agenda in 1986 for a variety of reasons. One reason it was added is that those involved in the financial markets face a "new reality" characterized by volatility, deregulation, new financial instruments and products, increased competition, securitization, increased buy and sell activity of a variety of instruments, hedging, asset/liability management, global markets, new technology, growth in off-balance-sheet derivative instruments, new regulatory capital rules and other changes in regulation. Further, those involved in the financial markets can no longer be neatly categorized as commercial banks, investment bankers, industrial companies, insurance companies, and so forth. The lines have become blurred and the distinctions less meaningful.

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In such an environment, the current accounting model for financial instruments (with its inconsistencies, voids, and patches) is probably not as useful or relevant as in earlier times. The logic behind different accounting by enterprises in different industries is less and less persuasive and there is increasing evidence that some of the existing accounting conventions are difficult to apply in practice.

The FASB is working on its project in segments. While the FASB will address a variety of key issues in its project, the pieces that relate to MVA are as follows:

The FASB Statement 107 on disclosure. Effective in 1992, it requires entities to disclose the market (or fair) value of most of their financial instruments (assets, liabilities, on- or off-balance-sheet).[1] It does not require disclosure of nonfinancial instruments, such as intangible assets, although this can be done voluntarily. Statement 107 represents a watershed point in the evolution of financial reporting but does not change actual measurements on balance sheets.

FASB exposure draft on accounting for debt and equity securities. This part of the project is being dealt with on an accelerated basis to resolve a current problem in practice (the so-called "investment versus trading" controversy). It is limited in scope, focusing on accounting for one asset category—securities. The exposure draft continues our mixed-attribute model, with accounting based on intent, but could lead to more investment securities being carried at market value. This project has generated the most controversy and press coverage.

FASB exposure draft on accounting for impairment of a loan. This part of the project is also being dealt with on an accelerated basis to resolve inconsistencies within the financial services industry. Although sometimes characterized as such, the exposure draft is not really about MVA per se but proposes to require a present value (discounting) approach to measuring impaired loans from a credit risk perspective. It does not address unimpaired (collectible) loans.

In addition, over the longer run, the FASB will examine broader recognition and measurement questions that deal with all financial instruments (assets and liabilities whether on- or off-balance-sheet). Ultimate resolution of the issues and timing are unknown at this point. The FASB's November 1991 Discussion Memorandum covers 10 primary issues, 50 issues, and 30 subissues. The board is currently working on hedge accounting questions that would affect balance sheet and income statement treatment of hedging instruments. It will move on to other issues in the future. MVA is a very contentious

[1] "Market value" and "fair value" are used interchangeably.

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matter—not only in the United States, but other countries as well. There are strong feelings on all sides of the issue.

A Conceptual Viewpoint

From a conceptual viewpoint, some positive things can be said about MVA, and they are generally consistent with Shaffer's analysis.

General-purpose financial statements are vehicles for communicating financial information concerning a business enterprise and they should provide relevant, reasonably reliable, and cost-effective information that assists users (principally investors and creditors) in making decisions. Users of financial statements are most interested in information that will help them in making informed judgments about future cash flows of an enterprise. These general beliefs lead some to the conclusion that the overall objective of financial statements should be to communicate information concerning the financial position of a business enterprise—the nature and *value* of its economic resources, the claims of creditors against the resources and the residual interest of owners in those resources, all at a specified date—and the changes in the nature and value of those resources, claims and interest for a specified period. Under that view, a value-based accounting system for financial instruments would attain that objective better than a historical-cost-based system.

Financial statements should communicate information concerning the future cash flows of the resources of a business. Some believe that the value of an enterprise's financial resources is more relevant to users of financial statements in meeting that objective than the historical or amortized cost of those resources. The value of financial instruments can be viewed as the most recent measure of the present value of future cash flows—a focus of analysis by users. Shaffer makes a similar point.

The role of financial reporting is not to value the enterprise as a whole (that is, the role of the stock market and the investor). Rather, its role is to recognize and measure individual assets and liabilities owned or owed by the enterprise and to help users with their functions. We should not confuse the role of financial reporting and the role of the user of financial statements. These views are fully consistent with the FASB's conceptual framework.

A Practical Perspective

Let me take a look at the accounting controversies that might be lessened or removed if we were to move to fair value accounting,

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from a practical perspective. Many of these controversies go beyond financial instruments and focus on transactions involving all long-term assets and liabilities, and, in part, respond to the impact of inflation, which we ignore today in our accounting model.

Consider the following examples (and there are more):

Accounting for business combinations. Fair value accounting would significantly reduce the differences between purchase and pooling-of-interests accounting for mergers and acquisitions. Accounting for goodwill would still be an issue.

Exchanges of nonmonetary assets. Our difficult-to-apply existing principles in this area would no longer be needed. The arbitrary percentages and definitions would be gone and the pressure to achieve gain recognition in marginal transactions would vanish.

Joint-venture formations. Questions of the necessary conditions to achieve step-up of contributed assets to fair value and gain recognition would not be present.

Hedge accounting. Issues of when to mark-to-market and when to defer gains and losses would be resolved. However, issues related to anticipated transactions would remain.

Debt extinguishment and troubled debt restructurings. Under fair value accounting, there would be no need to enter into in-substance defeasances to trigger a gain or force a conclusion that a restructuring involves troubled debt.

Leveraged buyouts and recapitalizations. Fair value accounting would reduce or eliminate the need for many of these transactions which are designed to achieve recognition of value increases inherent in a company's assets but for which no credit is given under historical cost accounting.

Accounting for investment securities. In some respects, this is part of the reason for discussion of this topic. Does it make sense for a transaction to trigger a gain or loss regardless of when the underlying change in value took place? Should it be possible to avoid a loss simply by not entering into a transaction? A gain or loss is just a phone call away. Further, MVA could eliminate a troublesome aspect of our current model of basing accounting on potentially changing management intent in response to a dynamic environment.

A couple of points should be made about these examples. First, MVA does not solve all of the problems associated with these transactions, but in many cases the transactions would not need to take place in the first place. To the extent transactions are eliminated or can be made less complex, transaction costs, sometimes incurred primarily to achieve either recognition of value enhancement or gains, would be minimized, thus increasing the efficiency of businesses.

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Second, while some practical problems would be solved with a MVA model, new ones would arise. Examples include developing methods for determining market value; concerns about reliability, comparability, and volatility, particularly if done piecemeal. If MVA were to be limited to financial instruments, concerns would arise about nonfinancial assets (e.g., core deposit intangibles, mortgage servicing rights, intangibles related to credit card customer relationships); and cost of implementation. Valuing liabilities presents some special challenges, such as whether an entity's own creditworthiness should be a factor in the valuation process.

Need for Input of Users

It is important that we obtain the input of users of financial statements because in a sense, that is what financial reporting is all about. In a study sponsored by the Association of Reserve City Bankers (1992), users indicated that they were very supportive of supplementing existing financial statements with fair value disclosures of financial instruments but were generally negative about adopting MVA as the primary basis for preparing financial statements. There are concerns about reliability and volatility. Apparently past volatility may not be useful to users in predicting the future.

A position paper entitled "Financial Reporting in the 1990s and Beyond" (1992) prepared by the Association for Investment Management and Research, the professional organization for the nation's financial analysts, investor advisors, and portfolio managers, stated the following:

> Any imminent change to "mark-to-market" accounting is not welcomed by the majority of financial analysts. They would not be happy to see historic costs removed from the financial statements. They are not convinced that there would be an increase in relevance sufficient to offset the reduction in reliability of the new data. Others disagree and are anxious to see and use market values in their work. In fact, the spectrum of opinion among analysts on the subject is so broad that it cannot be represented succinctly. Furthermore, it varies depending on the extent to which mark-to-market accounting would apply. Some would approve of it for financial instruments or some financial instruments, but not for tangible or other intangible assets. There is agreement, at least within the Financial Accounting Policy Committee, that marketable equity securities should be reported at market and that the disclosures of market values of financial instruments required by *Statement of Financial Accounting Standards 107* will provide potentially useful information without any corresponding loss of other data.

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More work needs to be done to further understand external users' needs and views. Although the needs of external users should be the focus, we also need to understand whether fair value information would be useful to managers of companies. Some financial institutions tell us they use the information in managing their business, compensating employees, etc.; others say they do not. Information actually used to manage an enterprise might also be useful to external users.

Some Additional Thoughts

Statement 107 is a good experiment. It could answer such questions as: Is it feasible to develop fair value data? Is the information useful, reliable, relevant, comparable? Disclosure (versus actual accounting) is a good place to start and seems consistent with Shaffer's views.

The FASB needs to complete its projects on investments in securities and loan impairment on a timely basis. Significant uncertainty exists under the existing accounting literature (the Security Exchange Commission is requiring restatements) and we need to reduce the uncertainty for all involved. The FASB's final statements need to be operational (as free as possible from ambiguity and second guessing) and should be consistent with the "new reality" of financial markets. We need a private-sector solution to these controversial issues.

It is probably unlikely that U.S. standards setters will go much further on MVA in the near term (i.e., beyond disclosures). We are likely to continue our mixed attribute model for a while, with some additional items being carried at fair value. Neither the SEC nor the FASB has been pushing on areas beyond investments in securities and measuring asset impairments, but we must continue to monitor domestic and international developments.

We need to be careful about the arguments concerning economic consequences of changes in accounting standards. Standards setting is supposed to be neutral—not trying to influence and discourage a particular activity or favor or discriminate against a particular industry or group. Ideally, financial reporting should fairly report the impact of decisions made and not cause a particular transaction to be done or not be done. Shaffer makes a similar point about investment portfolio accounting.

Really a Broader Question

The broad issue of fair value accounting generally arises in a discussion with respect to whether today's financial statements are sufficiently relevant. That is, are today's so-called historical cost-based financial statements useful to users—usually defined as investors and

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creditors—for making investment and credit decisions? To be sure, the criticisms of today's financial reporting do not rest solely—or in some cases even primarily—on concerns about the need to move toward MVA. Issues such as disclosures about risks and uncertainties, more prospective information and even information with respect to performance measures and benchmarking are among a whole series of questions that have been raised with respect to the adequacy of financial reporting today. The entire area is currently under study by the American Institute of Certified Public Accountants' (AICPA) Special Committee on Financial Reporting.

Others also have raised increasing concern about the relevancy of financial statements more generally and the concern focuses, at least in part, on the need to move toward market value in accounting. For example, organizations in the United Kingdom have issued five reports since 1975 addressing concerns about financial reporting.[2] While each study reached somewhat different conclusions, there was a consensus that annual reports are no longer useful to most users and a fundamental need exists for information about an entity's total wealth, the change in wealth for the period being reported and the reasons for that change.

The American Accounting Association (1990) has issued a report of the Committee on Accounting and Auditing Measurement. In that report the committee states:

> The defects of the present historical cost accounting systems are examined and are found to be formidable. In particular, it results in an income figure that cannot be relied on to maintain capital, however capital is defined, nor to distinguish good business decisions from bad ones. We are therefore led to the need for an income number that reflects changes in value more readily than earnings now does; and this in turn points to the wider use of current values in financial statements.

In a number of documents leading up to the formation of the Special Committee on Financial Reporting, the AICPA also focused on the perceived lack of relevance of historical cost financial statements. For example, in a "Report of the Future Issues Committee" the AICPA (1988) stated, "Financial reports are losing their significance because they are not future-oriented and do not provide value-based information."

In a similar fashion the AICPA (1990) concluded in its "Symposium on Financial Reporting and Standard Setting" that

[2]"The Corporate Report" (1975); "Making Corporate Reports Valuable" (1988); "Melody PLC Annual Report" (1990); "The Way Forward" (1990); "The Future Shape of Financial Reports" (1991).

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> financial reporting must change. In order to remain relevant, its value-based and forward-looking information content must be enhanced. This may require a gradual reengineering of the model.

Clearly, one of the AICPA's strategic thrusts for the future is to redesign financial reporting to make it more relevant, understandable, and beneficial to users. As Phillip Chenok (1992) stated:

> Alternatives to current financial reporting design should be considered and value-based, future-oriented information introduced into the process. Should appropriate and worthwhile alternatives not be considered, financial reporting could lose its significance and accountants their relevance.

Conclusion

In conclusion, the goal of financial reporting is to help users perform their role of valuing companies and assessing their prospects. Based on what we know, it would seem that information about the market value of individual assets and liabilities should be useful, particularly for financial instruments. But the issue may be more complicated. Perhaps the real questions are: When is market value information helpful in meeting the goal and when is it not? When is MVA (versus disclosure) useful? And when is disclosure alone sufficient?

We need to learn more about the answers to these questions. If fair value information is useful, it probably is a good strategy to adopt an evolutionary approach to changes in accounting standards, starting with disclosure, like Statement 107. Any changes in balance sheet measurements should (1) be as equitable as possible (assets and liabilities) so that reporting of an enterprise's overall position is most meaningful; (2) be useful to users of financial statements; and (3) give consideration to the need for a level playing field across industries and international concerns (e.g., harmonization of accounting standards). We also need to be sensitive to cost-benefit considerations—i.e., the cost to develop the data versus the benefit to users. We need to be flexible with regard to methods for determining value information. And for some assets, liabilities, and off-balance-sheet items, amortized cost-traditional accrual accounting may be a practical surrogate for market value and still provide relevant information.

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Financial Innovation and Deposit Insurance: The 100 Percent Cross-Guarantee Concept

Bert Ely

Dramatic changes in recent decades in the economics of the financial services industry, due largely to the computer revolution, have destroyed the efficacy of traditional financial services regulation. Despite these developments, the federal government has merely tinkered with the current regulatory system. Such tinkering is counterproductive because the current rigid, central-planning style of financial services regulation is inherently flawed. Instead, we must create a market-driven regulatory model that gives individual banks and thrifts the flexibility to pursue unique business strategies.

The 100 percent cross-guarantee concept is a reform proposal that would meet this test. Embodied in legislation introduced in September 1992 by Rep. Tom Petri (R.-Wis.), its implementation will quickly lead to better-priced and therefore wiser bank lending while eliminating the risk federal deposit insurance now poses to taxpayers. Cross-guarantees also will end "regulatory arbitrage," that is, the flight of lower-risk assets from banks and thrifts to less-taxed and less-regulated channels of financial intermediation. America would have a safer and more efficient financial system as a result.

The Traditional Regulatory Model

The traditional regulatory model for depository institutions emerged in the United States during the 19th century. Entry into banking was restricted and banks and thrifts were highly regulated as to their capital, liquidity, and lending. These regulations were enforced by bank examiners and supervisors under the premise that individual

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banks and thrifts needed to be protected from failing so that depositors (and noteholders prior to the federalization of currency issuance in 1863) would not suffer losses.

To work satisfactorily, the traditional regulatory model requires three conditions:

- *Slow rate of change.* Effective regulation depends on a slow rate of change because the political process cannot respond quickly enough to rapidly changing conditions due to the time it takes to overcome political resistance posed by those interests adversely affected by change.
- *Segregation of the regulated.* In order to regulate effectively, the regulator must be able to easily identify its charges. This task is made much simpler by controlling entry into the regulated field and by prohibiting unlicensed firms from engaging in the regulated activities.
- *Homogeneity among the regulated.* Because of its one-size-must-fit-all nature, regulation effectively fosters homogeneity among the regulated. In other words, regulation tends to lead to one logical way to conduct a business.[1] A relatively uniform style of operation also makes it easier for the regulator to monitor and control the enterprises it regulates.

Government regulation of financial services shows certain characteristics of central planning as it was practiced in the former Soviet Union and in Eastern Europe. Like central planning, banking regulation focuses on micromanaging individual enterprises, specifically by giving directives to the regulated as to what they must do (the Community Reinvestment Act and minimum capital requirements, for example), what they cannot do (branch across state lines, underwrite corporate stocks, or broker real estate), and what they are discouraged from doing, such as making limited documentation loans to small businesses. One cannot help but be struck by the fact that federal micromanagement of banks and thrifts has increased exponentially as the rest of the world rapidly sheds socialism and communism.

Traditional Banking Regulation Did Not Work Well

The traditional regulatory model seemed to work well until the 1980s, as evidenced by the low number of bank and thrift failures from 1934 to 1980, the absence of visible signs of strain within the

[1]For example, uniform capital requirements and regulatory restraints on high-risk lending effectively limit banks and thrifts to holding a narrower range of assets than would be the case if they were less regulated.

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financial system, and—after World War II—economic stability marked only by occasional recessions. One reason for this apparent calm was that the technology directly employed in the production and delivery of financial services changed relatively little during the first half of this century, after a burst of innovation between 1867 and 1889 (Cortada 1993: 283).[2] Even the early computers did not represent major change since they were not widely used. Consequently, this slow rate of technological change did not materially alter the economics of the financial services industry or significantly affect its structure.

However, one technological innovation outside of financial services, the development of the rubber tractor tire in the early 1920s, wreaked havoc on the small rural banks of that era. The rubber tractor tire permitted the paving of farm-to-market roads[3] which, in turn, enabled farmers to drive to larger, more distant towns that had bigger banks. From 1921 to 1931, surfaced rural roads increased from 13.2 percent of all rural highway mileage to 27.3 percent.[4] Not surprisingly, the average number of cars and trucks per farm increased from .3 to .8 as paved roads made auto travel less wearing (Ely 1988: 53). In effect, these developments fostered the decimation of a unit banking system that was further damaged by the broad asset deflation of the early 1930s. It is ironic that, even though the Great Depression should have put the advocates of traditional banking regulation on the defensive, particularly with regard to branching restrictions, New Deal banking legislation *increased* banking regulation while continuing to tolerate state-mandated branching restrictions.

While bank regulation may seem to have worked well after the New Deal banking "reforms" were enacted, the highly regulated banking system remained vulnerable to rapid changes that finally began to blossom during the 1970s.

[2]Key inventions during this 22-year innovative spurt, according to Cortada, include the typewriter (1868), stock ticker (1870), telephone (1876), cash register (1879), fountain pen (1884), adding machine (1885), comptometer (1887), and punch card accounting (1889). Other inventions of this era, such as the electric light (1879), and the electric elevator (1889), also facilitated the production and delivery of financial services. Although electronic technology, and specifically the computer, can be traced back to World War II, the full impact of this new technology probably did not begin to materially affect the production and delivery of financial services until the late 1970s; more recently, widespread use of personal computers has greatly accelerated the impact of technology on the production and delivery of financial services.

[3]Before the development of rubber tractor tires, country roads could not be paved because steel tractor tires quickly shredded the pavement.

[4]"Historical Statistics," Series Q51, Q56, (1975): 710.

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Electronic Technology and Regulatory Arbitrage

Electronic technology, notably the personal computer, has dramatically altered the economics of producing and delivering financial services. These altered economics have irreversibly undermined the traditional regulatory model, specifically by harming the competitiveness of highly regulated financial institutions due to the rigidities imposed by government regulation. It is obvious that electronic technology changes far faster than the regulatory process can adapt to these changes. Technology is knocking down barriers separating highly regulated institutions from the rest of commerce, a trend that is introducing heterogeneity into the regulated industries. Attempts to preserve the traditional rigid regulatory model have succeeded only in perversely impairing the efficiency of producing and delivering financial services, hence increasing the overall riskiness of the financial system.

This multi-faceted impact has occurred because computers have increasingly permitted the unbundling, or separation into their constituent parts, of the legal contracts that are the common denominator of all financial services and products.[5] This unbundling, in turn, has resulted in the emergence of unregulated firms that perform pieces of financial services transactions. Previously, in their bundled form, these transactions could only have been performed by the highly regulated, traditional firms. In effect, these relatively unregulated financial services firms engage in *regulatory arbitrage* by using the computer to lawfully evade regulatory costs and strictures.

Home mortgages represent an excellent example of this unbundling process and the consequent regulatory arbitrage. The traditional S&L used to make or originate a fixed-rate mortgage, fund it with deposits it gathered through its branches, and service it by collecting monthly payments and performing other periodic tasks associated with holding a mortgage. The computer has unbundled the typical fixed-rate home mortgage into three distinct pieces—origination, funding, and servicing. Banks and independent mortgage bankers now originate many mortgages; most funding of fixed-rate mortgages is now provided by Wall Street through the asset securitization process; and servicing is now a highly automated process in which many non-financial firms compete.

The political process has not blocked regulatory arbitraging because successful arbitragers, such as mutual fund managers, the commercial paper market, asset securitizers, and producers of financial derivatives

[5]Examples of legal contracts that constitute financial services include checks, loans, stocks, bonds, insurance contracts, real estate leases, and trust agreements.

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have gained sufficient political power to reinforce the regulatory barriers within the financial services industry that have helped to create these arbitraging opportunities. It appears that the less regulated, and therefore more entrepreneurial, firms are more effective politically in advancing or defending their interests than are highly regulated bankers.

Rapid technological change will continue for the foreseeable future. Moore's Law and Joy's Law do not seem to be abating.[6] Consequently, the adverse impact of computer technology on the traditional regulatory model will continue. In an absolute sense, the rate of change in the computer world is accelerating—doubling the number of transistors on a chip from 1 million to 2 million is much more significant economically than the doubling from 32,800 to 65,500 that took place five iterations (8 years) previously.

Direct Consequences of Regulatory Arbitrage

Regulatory arbitraging probably began in the 1960s; it certainly accelerated rapidly during the 1980s, as evidenced by the increased flight of lower risk financial assets to less-taxed and less-regulated channels of funds intermediation. Regulatory arbitraging of specific financial products and services occurs as soon as the cost of executing the arbitrage drops below the amount saved by doing the arbitrage. Arbitrage costs largely represent real resource consumption, such as employing MBAs, lawyers, and other highly educated personnel equipped with sophisticated computers. Arbitrage savings usually consist of lawfully avoiding the cost of excessive capital requirements, overpriced deposit insurance, and other unnecessary regulatory costs and taxes that do not represent the consumption of real economic resources.

The easiest regulatory arbitrages occurred first. They included the shift of low-risk commercial loans to the commercial paper market and the securitization of home mortgages. The latter arbitrage has effectively been subsidized by the taxpayer since securities guaranteed by two key government-sponsored-enterprises, Fannie Mae (Federal National Mortgage Association) and Freddie Mac (Federal Home Loan Mortgage Corp.), carry a lower rate of interest than securities guaranteed privately.

[6]Moore's Law, named after Gordon Moore, a co-founder of Intel Corp., holds that the number of transistors per computer chip doubles every 18 months, which equals a compound annual growth rate of 59 percent. Joy's Law, named after William Joy, a co-founder of Sun Microsystems, holds that computer microprocessor speeds increase exponentially every 12 months. (Markoff, J. *New York Times*, 29 December 1991: F5.)

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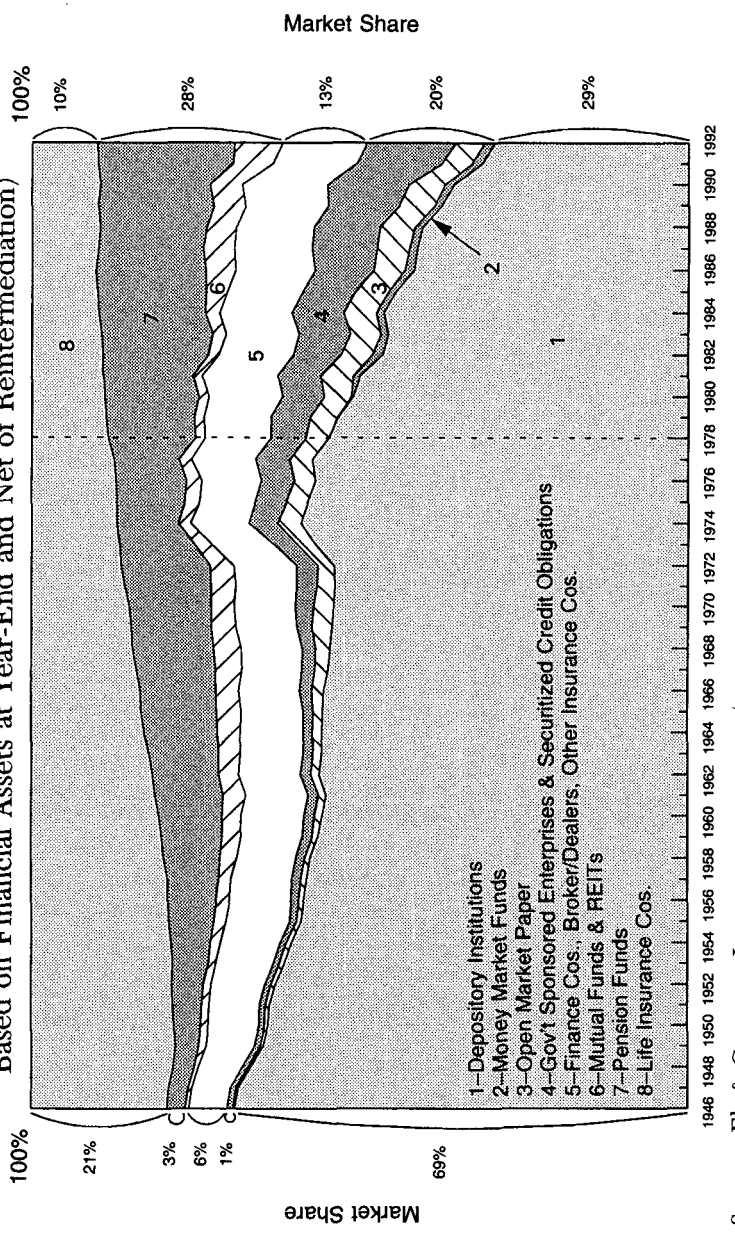
FIGURE 1

FINANCIAL INTERMEDIATION IN THE UNITED STATES
(Market Share Held by Major Channels of Intermediation,
Based on Financial Assets at Year-End and Net of Reintermediation)



SOURCE: Ely & Company, Inc.

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Regulatory arbitrages that are more costly to execute occur only if the achievable regulatory cost saving rises sufficiently to make the arbitrage profitable. Recent banking legislation, notably the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the regulations they have spawned have broadened the range of feasible arbitrages. As Figure 1 illustrates, the market share of highly regulated depository institutions (banks, thrifts, and credit unions), based on assets held on-balance-sheet, declined from 69 percent of total assets held by financial intermediaries at the end of 1946 to 29 percent at the end of 1992; that percentage is continuing to decline this year. This market share has shifted to the less-taxed and less-regulated channels of intermediation (bands 2 to 7 in Figure 1). This market share shift undoubtedly will continue as the impact of FDICIA, and the regulatory "reign of terror" it unleashed, further tightens the regulatory noose choking depository institutions.

Drawbacks of Regulatory Arbitrage

Regulatory arbitrage has three significant drawbacks. First, the flight of low-risk assets out of highly regulated and highly taxed institutions has the perverse effect of increasing the average riskiness of the assets retained by these institutions. Unfortunately, many banks, thrifts, and life insurance companies began pursuing riskier assets at the same time, during the early 1980s, in order to earn higher yields to compensate for higher regulatory costs while preserving deposit and insurance franchises which were collecting funds that no longer could be profitably invested in low-risk assets. This collective rush for high-yield, high-risk assets (junk bonds, commercial real estate loans, and so forth) led to a collective oversupply of credit that stimulated the commercial real estate bubble discussed below.

If the traditional regulatory model had worked properly, technology would have affected only the ability of depository institutions to attract deposits through branches. It should have had little, if any, effect on the ability of banks and thrifts to intermediate into low-risk assets whatever deposits they could gather. Put another way, increases in the relative cost of gathering deposits through branches should be borne by depositors, not borrowers.

Second, regulatory arbitraging has been very costly to the American economy. Ironically, this form of arbitraging consumes far more *real* resources than it saves. This outcome is contrary to the rationale for arbitraging, which is to enhance economic efficiency by lessening or eliminating price discrepancies between markets.

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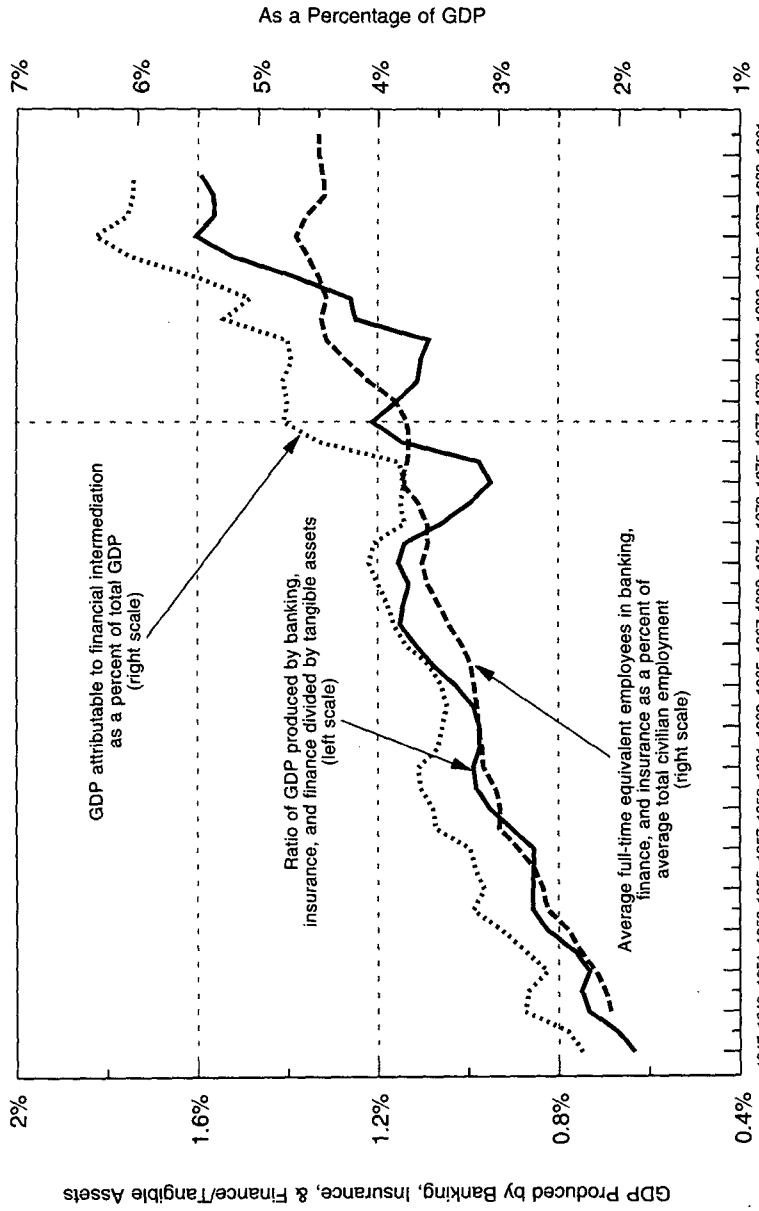
FIGURE 2

RELATIVE PRODUCTIVITY OF FINANCIAL INTERMEDIATION


As a Percentage of GDP
7%
6%
5%
4%
3%
2%
1%
GDP Produced by Banking, Insurance, & Finance/Tangible Assets
2%
1.6%
1.2%
0.8%
0.4%
GDP attributable to financial intermediation as a percent of total GDP (right scale)
Ratio of GDP produced by banking, insurance, and finance divided by tangible assets (left scale)
Average full-time equivalent employees in banking, finance, and insurance as a percent of average total civilian employment (right scale)
1947 1949 1951 1953 1955 1957 1959 1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989 1991

SOURCE: Ely & Company, Inc.

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As Figure 2 illustrates, the relative productivity of the financial services industry (banking, finance, and insurance) has declined by over half since the end of World War II. In effect, it takes more than twice as many resources today as it did at the end of World War II, relative to the overall size of the economy, to finance a dollar of GDP or a dollar of tangible assets. This deterioration in relative productivity has occurred despite the extensive computerization of the financial services industry over the last 15 to 20 years. Regulatory arbitrage is the key villain in this deterioration. Had productivity growth in financial services matched the rest of the economy in the post-war era, banking, finance, and insurance activities in 1991 would have consumed $150 billion less in real economic resources (Ely 1992: 358–60). To a great extent, this $150 billion figure represents fees, salaries, and related costs incurred in the nonregulated segments of the financial services industry. Not surprisingly, these segments of the financial marketplace participate actively in the political process to preserve politically mandated marketplace inefficiencies.

Third, regulatory arbitraging increases taxpayer risk outside of the banking system. This increased risk occurs because non-depository institutions generally do not have an established mechanism comparable to the deposit insurance tax (euphemistically called an insurance premium) to assess surviving firms for losses incurred in protecting creditors of failed firms. Exceptions to this statement are the Securities Investor Protection Corporation for customers of broker-dealers and state guarantee funds for insurance companies.

If a liquidity crisis strikes the money market mutual funds or the commercial paper market, the Federal Reserve, in order to maintain financial stability, will be forced to provide emergency liquidity to those institutions experiencing runs or unable to roll over maturing debt.[7] Despite its professed insistence on lending only on a fully collateralized basis, the Fed may take a loss from this lending. Since the Fed is merely an extension of the U.S. Treasury, any loss the Fed suffers will be borne by taxpayers, because "any such loss would reduce the [Fed's] annual payments to the Treasury and thereby increase the Federal deficit" ("Budget Baselines" 1993: 182).

Mispriced Deposit Insurance—a Key Failing of the Traditional Regulatory Model

The regulatory arbitraging unleashed by electronic technology has revealed a key failing of the traditional regulatory model—mispriced

[7]Rep. Tom Petri (R.-Wis.) raised the issue of this potential risk to Richard Darman, then Director of the Office of Management and Budget, in letters dated September 3, 1992,

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deposit insurance. Mispriced deposit insurance essentially caused the S&L crisis and contributed greatly to the several speculative bubbles that emerged during the 1980s.

Deposit insurance pricing can best be understood as an option pricing problem. All insurance contracts are option contracts—the insured has an option on the insurer's capital if an insured loss occurs. Consequently, an insurance premium is an option price. The price of the deposit insurance option must, accordingly, be fully reflected in the interest rate banks and thrifts charge on their loans and seek in the yields on their investments if an optimal balance is to be struck between deposit insurance losses and the risks being taken by insured institutions. In effect, the deposit insurance premium rate or option price must become the third element in calculating a bank or thrift's cost of funds, as illustrated in Figure 3. The cost of deposits and borrowed funds and the targeted rate of return on the lender's equity capital are the other two elements that must be factored into a cost of funds calculation.

Option pricing has played absolutely no role in the traditional regulatory model even though the primary purpose of "safety-and-soundness" regulation today is to minimize deposit insurance losses. That is, the regulatory process has made no attempt to use deposit insurance pricing to dissuade banks and thrifts from making loans and investments that could cause deposit insurance losses in excess of total deposit insurance premiums. Instead, the regulatory process has relied exclusively on *ex ante* rules and *ex post* supervision of banks and thrifts to moderate their risk-taking. The rules and supervision have not worked well, as the enormous deposit insurance losses of the last 12 years attest. Put another way, the traditional regulatory model does not foster accurate pricing of banking risks for the threat of loss these risks pose to the deposit insurer.

For two reasons, the price banks and thrifts now pay for their deposit insurance under the FDIC's new risk-based assessment system bears no relationship to the potential cost of failure posed by new risks FDIC-insured banks and thrifts have assumed. First, the FDIC's new assessment scheme implemented on January 1, 1993, is largely based on bank capital, which is a lagging measure of banking risk, whereas the marketplace will price deposit insurance based on leading indicators of risk, such as excessive loan concentrations. Second, the traditional regulatory model will never be able to properly price the

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and October 6, 1992, and again in a February 26, 1993, letter to Leon Panetta, the current OMB director. Copies of these letters, as well as replies from Mr. Panetta and Federal Reserve Chairman Alan Greenspan, can be obtained from the author or Rep. Petri's office.

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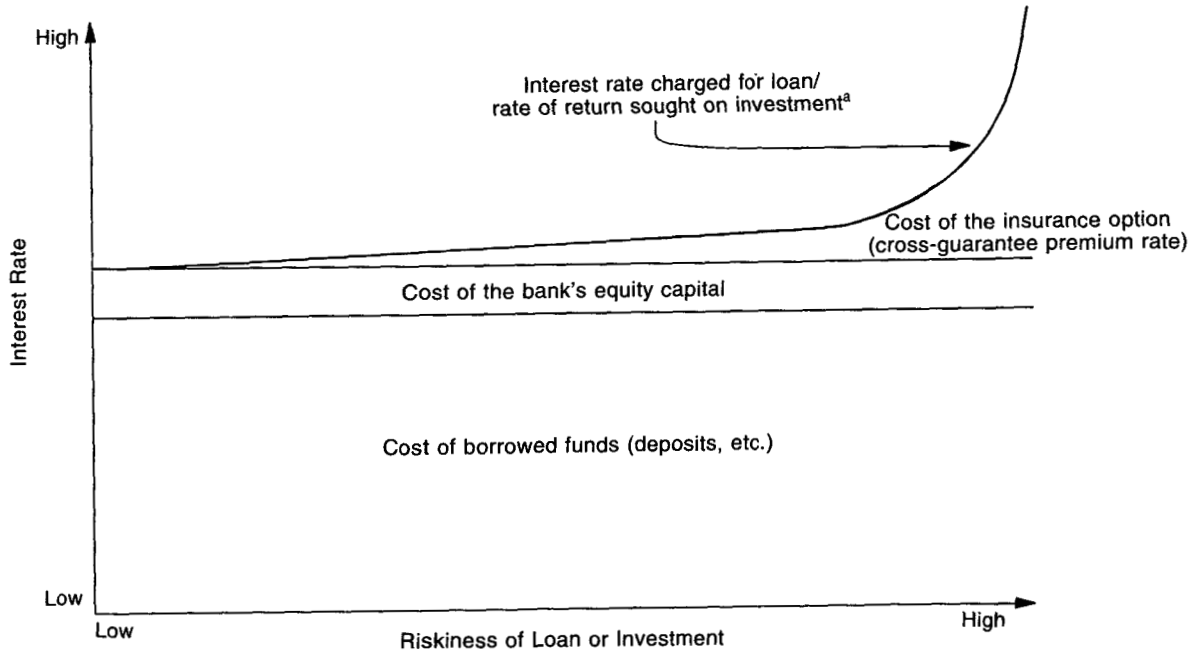
FIGURE 3

RISK AND THE COST OF THE INSURANCE OPTION



[a] The interest rate to be charged excludes the bank's overhead expense and an allowance for expected losses.

SOURCE: Ely & Company, Inc.

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insurance risk posed by loans and investments because a government monopoly will never have the political freedom or the marketplace signals needed to properly price this risk (Scott and Mayer 1971: 893). For example, the FDIC currently charges a "risk-sensitive" premium rate that ranges from .23 percent to .31 percent per dollar of domestic deposits. By contrast, premium rates established by the marketplace most likely would range from less than .02 percent to .60 or .70 percent of deposits.

Two Consequences of Mispriced Deposit Insurance

The S&L crisis. Properly priced deposit insurance would have prevented the S&L crisis because risk-sensitive pricing would have made maturity mismatching (using short-term deposits to fund long-term, fixed-rate loans) uneconomic for S&Ls. Instead, S&Ls would have used deposits to fund adjustable-rate mortgages (which for political reasons were barred for federally chartered S&Ls until 1981) and they would have securitized the fixed-rate mortgages they issued or funded the fixed-rate mortgages they held with long-term, callable bonds and deposits. Because the dangers of maturity mismatching were well-understood long before the 1960s,[8] deposit insurance premium rates would have skyrocketed after the interest rate spike that occurred in 1966, if not after one of the three earlier post-war rate spikes.

Not surprisingly, perhaps, the traditional regulatory model tolerated maturity mismatching. In fact, after the 1966 rate spike, Congress tried to preserve maturity mismatching by extending the Federal Reserve's Regulation Q deposit interest rate controls to S&Ls. This fix to the traditional regulatory model lasted until the interest rate explosion in 1980–82 when nominal interest rates rose to record heights. These high rates temporarily rendered most S&Ls insolvent on a market-value basis, permanently bankrupted hundreds of S&Ls, and created the environment for the gross regulatory mismanagement of the S&L crisis that exists right up to the present time.

Attempts to prevent another S&L crisis, and a perceived crisis among commercial banks, led to draconian banking legislation, notably FDICIA, that has strangled commercial banking. This occurred despite the fact that, because of its different mission and financial structure, banking has experienced far fewer deposit insurance losses

[8]The textbook the author used in a college finance course in the spring of 1964 devoted a 21-page chapter to interest-rate risk; its index includes 20 references to interest-rate risk (Sauvain 1959: 112–32).

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than thrift institutions (S&Ls and savings banks).[9] FDICIA and its predecessor, FIRREA, The Financial Institutions Reform, Recovery and Enforcement Act of 1989, essentially reflect Congress's enormous distrust of the regulators arising from the S&L crisis. However, as is typical of the political process, Congress, when finally aroused, applied the wrong solution by placing increased reliance on the traditional regulatory model, one consequence of which has been to broaden the opportunity for regulatory arbitraging.

Bursting speculative bubbles. Properly priced deposit insurance should impede the emergence of speculative bubbles and quickly temper any bubbles that begin to form. The first two types of bubbles discussed below that emerged during the 1980s were inflated by underpriced credit. Credit can be underpriced for two reasons. First, misguided government monetary policies may depress real interest rates; real rates may even be negative for a period of time, as occurred occasionally in the United States during the 1970s. Borrowing to finance speculative investments looks very attractive when real rates of interest are low or negative.

Second, lenders pumping credit into inflating bubbles may not include a sufficient loss allowance in the interest rates they charge to cover the losses they will incur when the bubble bursts. Credit clearly has been underpriced if losses caused by a bursting bubble later wipe out not only the speculators, but many of the lenders who extended credit to the speculators. Credit will turn out to be properly priced only if a bursting bubble does *not* cause the failure of the lenders who provided the credit that helped to inflate the bubble. (Speculators may be bankrupted, but they are not a regulatory concern because taxpayers should not protect equity investors from their speculative excesses.)

Properly priced deposit insurance will dramatically increase the likelihood that credit being used to inflate speculative bubbles will be priced high enough to cover likely losses. As illustrated in Figure 3, if the lender does not charge enough to cover prospective losses from a bursting bubble, the insurer should more than make up for that pricing shortfall by charging a higher premium to compensate for the losses *it* faces if the lender fails. The lender will then have to pass the higher premium through to its borrowers or suffer low profits or a negative return on its capital, conditions that the lender's stockholders should not tolerate for long.

[9]After adjusting for inflation, losses in failed commercial banks, as a percentage of total domestic deposits in all commercial banks, have been approximately one-tenth the loss rate experienced by thrift institutions.

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Three Bubbles that Burst During the 1980s

Three speculative bubbles burst during the 1980s, each of which did substantial damage to banking. Mispriced deposit insurance and comparable unpriced state-mandated guarantees for life insurers were a prime cause of these bubbles.

Farm land prices were the first bubble that popped in the 1980s. Farm land prices almost doubled, in inflation-adjusted terms, from 1971 to 1980, due largely to extremely cheap credit supplied after 1971 by an agency of the federal government, the Farm Credit System (Ely and Vanderhoff 1990). Record high interest rates in the early 1980s punctured this bubble. From 1980 to 1986, the inflation-adjusted value of farm land dropped back almost to its level of 1971. This burst bubble contributed to the failure of almost 300 agriculturally related commercial banks during the 1980s and led to a taxpayer bailout of the Farm Credit System.

The oil price bubble burst in 1981 after crude oil prices had more than tripled since 1973, in inflation-adjusted terms, as a result of the Arab oil boycott and the Iranian oil embargo. Long-standing U.S. price and allocation controls over domestic crude oil production exacerbated the effect of those two events. By 1986, the inflation-adjusted price of crude oil had plunged by more than two-thirds. The number of oil drilling rigs declined by three-fourths during the same five year period, undermining the value of collateral securing many loans tied to oil and gas exploration. Real estate values in the energy producing states also plunged, especially for commercial properties. These asset deflations greatly aggravated the S&L crisis and bankrupted hundreds of commercial banks in the energy states.

The commercial real estate bubble outside of the energy producing states was a creature of the 1980s. This bubble was fostered in part by the 1981 Tax Act's liberalized depreciation allowances and in part by a sharp increase in commercial real estate lending by banks, thrifts, and life insurance companies. From 1983 to 1989, total bank and thrift lending for construction and permanent loans on nonresidential real estate (except farm land) increased 131 percent, more than 2.4 times the 54 percent growth in nominal Gross Domestic Product (GDP) in those years. Life insurers nearly doubled their holdings of nonresidential mortgages between 1983 and 1989. This occurred despite the fact that the national office vacancy rate tripled to 14 percent, from 1982 to 1984, and kept on climbing after that to a late 1980s' peak of 17–18 percent, where it has remained. The asset deflation driven by this overbuilding and the subsequent collapse of rental rates has caused billions of dollars of losses for depository

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institutions and life insurers. Clearly, these intermediaries underpriced their commercial real estate loans.

The damage from the deflationary aftermath of bursting bubbles extends to an entire economy, as evidenced by the prolonged recovery from the most recent recession in many industrialized nations, notably the United States, Great Britain, the Scandinavian countries, and Japan. Recovery is prolonged because, while nominal debts remain constant, asset deflations dramatically lower the net worth of many individuals and businesses, raising their effective leverage ratio. Income streams also are often impaired as assets lose value, making it even harder for borrowers to service their debts. In these circumstances, debtors aggressively rebuild their balance sheets by paying down their debts to reduce leverage ratios and debt servicing burdens. Demand for capital goods will be sluggish as long as this debt liquidation proceeds; the economic recovery will be correspondingly slow and painful.[10]

Deflation appears to be more demoralizing to the populace than inflation, perhaps because it is easier to protect oneself against inflation than deflation. This may be why populism, and its more extreme form, fascism, rear their ugly heads during deflationary times, as the world experienced in the 1930s. Populism essentially blames "the other guy" for economic difficulties. During the recent deflation-driven recession, we have seen its resurgence.

A New Regulatory Model: 100 Percent Cross-Guarantees

The United States clearly needs a new regulatory model as the traditional regulatory model is hopelessly beyond repair. Specifically, the new model must rely much more than the traditional model does on market forces, specifically on properly priced deposit insurance, to promote wise and efficient lending and investing with a minimum of regulatory arbitraging. The following features should characterize the new regulatory model:

- Government regulation should concern itself only with maintaining the stability of the financial system, not the fate of individual firms within that system. However, stability should be ensured in a manner that protects taxpayers from all losses when individual firms fail.

[10]For one of the purest examples of a bursting bubble and its painful deflationary aftermath, see Ely and Vanderhoff (1990).

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- Individual financial intermediaries should have the freedom to specialize in whatever activities they choose, subject only to market constraints.
- Individual firms should be permitted to fail, since failure is a necessary element of all successful marketplaces.
- The marketplace should establish a premium rate formula, institution by institution, for deposit insurance. As Figure 3 illustrates, a bank or thrift would then incorporate in the interest rate it charges or the investment yield it seeks the effect a particular loan or investment would have on its premium rate.

The major public policy challenge in banking today is designing a deposit insurance mechanism that meets the above criteria. The 100 percent cross-guarantee concept meets this challenge. There may be other ways to meet it, but they have not yet surfaced. All proposed reforms of federal deposit insurance, including FDIC reinsurance and the "narrow bank" and its ilk, are merely futile attempts to rebuild Humpty-Dumpty. The cross-guarantee concept is embodied in the Taxpayer Protection, Deposit Insurance Reform, and Regulatory Relief Act of 1992 (H.R. 6069), a 173-page bill that Rep. Tom Petri introduced on September 30, 1992. Key features of the Petri bill are as follows:

- Cross-guarantee contracts must protect all deposits, domestic and foreign, as well as most other liabilities and all off-balance-sheet commitments, such as letters of credit, option and futures contracts, swaps, and so forth. This requirement effectively shifts *all* insolvency risk for banks and thrifts, beyond that provided by stockholders, to ad hoc syndicates of guarantors who explicitly assume that risk in exchange for a risk-based premium. Shifting this insolvency risk to guarantors will eliminate depositors as a potential source of financial instability and banish concerns about banks considered to be too-big-to-fail.
- Cross-guarantee contracts will give the marketplace the opportunity to develop market-driven, risk-sensitive pricing focused on *leading* indicators of banking risk. This type of pricing will help enormously to starve emerging speculative bubbles of underpriced credit, thereby reducing greatly, if not eliminating, the subsequent deflationary consequences of bursting bubbles. Market-driven pricing, in concert with other aspects of cross-guarantees, will in turn eliminate the incentive for the financial markets to engage in the wasteful regulatory arbitraging that has become so widespread in recent years.

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- Cross-guarantee contracts also will contain contractually agreed-upon restrictions on a bank or thrift's activities and specify the right of the syndicate to employ an agent (called the syndicate agent) to work inside the institution to monitor, on a real-time basis, its financial condition and risk-taking. The syndicate agent will collect a separate monitoring fee from the guaranteed institution for this work. Figure 4 illustrates the relationship of the various parties to a cross-guarantee contract.
- Every bank and thrift eventually must obtain a cross-guarantee contract, if the cross-guarantee system reaches "critical mass," which is defined in the Petri bill as 250 banks and thrifts, with $500 billion in total assets, having obtained cross-guarantee contracts. If the system does not reach critical mass, the system will not activate. If it does activate, institutions with more than $1 billion in assets will have 2 years to obtain a contract; those with less than $25 million in assets will have 8 years.
- The Petri bill exempts guaranteed banks and thrifts from all federal safety-and-soundness requirements, such as uniform capital standards, lending limits, and restrictions on insider borrowings. Safety-and-soundness concerns will become the sole province of the contract negotiated between a guaranteed institution and its syndicate of guarantors. (The bill provides generous severance pay for the 15,000–20,000 bank and thrift examiners and supervisors whose jobs will become redundant under the cross-guarantee system.)
- To maintain depositor confidence in guaranteed banks and thrifts during the early years of the cross-guarantee system, the Petri bill creates a Backup Fund, or BUF, to protect deposits up to the present $100,000 deposit insurance limit. In reality, the BUF should never experience a loss because of the cross-guarantee system's systemic safeguards discussed below. Indeed, the BUF essentially is a political facade to permit guaranteed institutions to continue to display the FDIC insurance sticker until such time as depositors have adapted to relying on a second sticker stating that all deposits are protected under a cross-guarantee contract.
- Bank runs should never occur because deposits will be fully guaranteed. If a run does develop, guarantors should have sufficient liquidity to snuff it out. The Federal Reserve also could provide emergency liquidity to a guaranteed bank or thrift without risk, since all such advances will be fully guaranteed under that institution's cross-guarantee contract.
- To ensure that even the smallest bank or thrift can obtain a cross-guarantee contract, the Petri bill authorizes "group cross-

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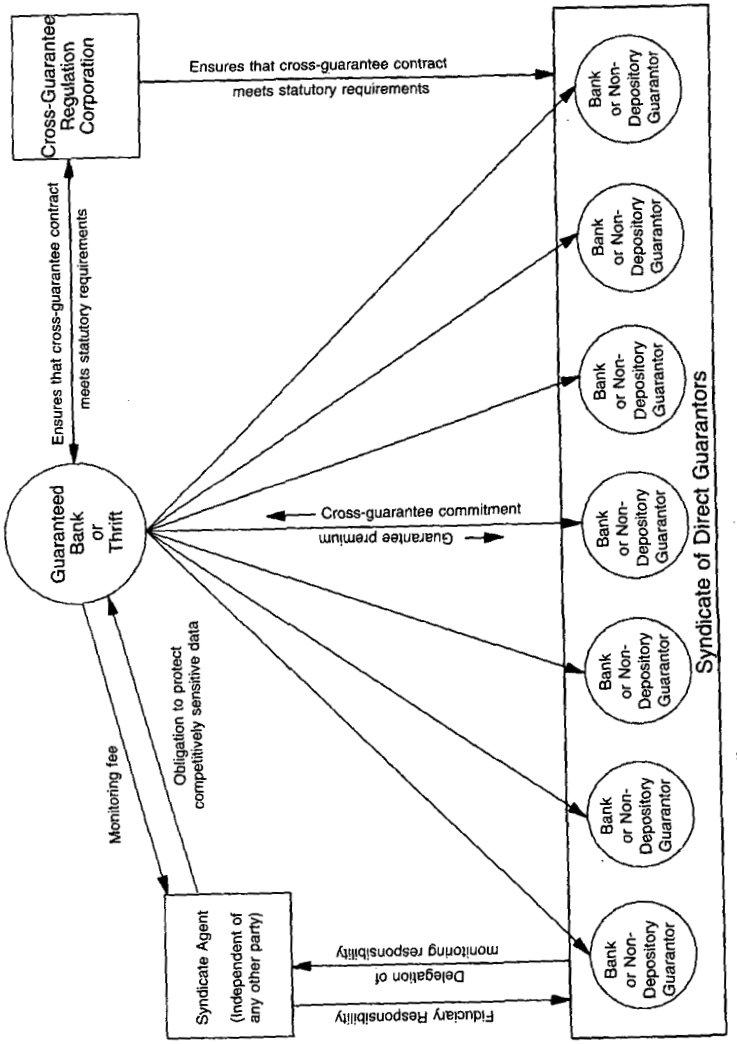
FIGURE 4

PARTIES TO A 100 PERCENT CROSS-GUARANTEE CONTRACT


Cross-Guarantee Regulation Corporation
Ensures that cross-guarantee contract meets statutory requirements
Ensures that cross-guarantee contract meets statutory requirements
Guaranteed Bank or Thrift
Cross-guarantee commitment
Guarantee premium
Monitoring fee
Obligation to protect competitively sensitive data
Syndicate Agent (independent of any other party)
Delegation of monitoring responsibility
Fiduciary Responsibility
Bank or Non-Depository Guarantor
Syndicate of Direct Guarantors

SOURCE: Ely & Company, Inc.

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guarantee contracts." Under group contracts, individual contracts of many small banks and thrifts scattered around the country can be pooled for risk syndication purposes as if they were one large bank. This is an important provision since smaller banks and thrifts generally will find it cheaper to be guaranteed under group contracts than under a contract under which they are the sole guaranteed party.

Very simply, the cross-guarantee concept is a self-insurance mechanism for banks and thrifts that completely replaces the existing system of federal deposit insurance. Under this concept, all deposits and most other liabilities of a bank or thrift will be unconditionally guaranteed against any loss under a contract with an ad hoc syndicate of voluntary guarantors. The bank or thrift, in turn, periodically will pay a risk-sensitive premium or fee to its guarantors to compensate them for the risk they have assumed. The guarantors, acting through a syndicate agent, also will have the right to monitor the activities and financial health of the bank or thrift they are guaranteeing.

Building Systematic Safety Into Cross-Guarantees

The cross-guarantee concept eliminates all taxpayer risk from deposit insurance through uniform risk-dispersion rules and other systemic safety requirements. While the marketplace would insist on many of these rules, four statutory requirements provide uniformity where needed and more than adequate political comfort about the soundness of the cross-guarantee system.

First, each guarantor must itself be guaranteed by a syndicate of guarantors. Further, at least one of the guarantors in each syndicate must be contractually linked, directly or indirectly, to every other guarantor in the entire system. This requirement ensures that no "isolated closed loops" will ever exist within the cross-guarantee system. An isolated closed loop would exist if a small group of banks and thrifts guaranteed each other, but had no contractual links, for cross-guarantee purposes, with the rest of the system. In effect, the entire cross-guarantee system must form one giant network or closed loop to ensure that no loss, however large, will ever leak from the system. Preventing loss leakage is why *the cross-guarantee system will be stronger financially than even the federal government.*

Second, a uniform "stop-loss" requirement (in effect, a mandatory reinsurance mechanism) will pass through to each guarantor's own set of guarantors all losses in a 12-month period that exceed 5 times the premium income the guarantor earned during that period. Hence, a guarantor's maximum loss as a guarantor in any one year will be

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limited to an amount equal to 12 percent of its capital. For most guarantors, that amount would equal 6 to 9 months of its pre-tax income. Losses of this magnitude, which should be extremely rare, will sting, but not bankrupt a guarantor, reflecting a basic principle of the cross-guarantee concept—no guarantor should ever fail by virtue of being a guarantor. The stop-loss limit will ensure that a large loss or a series of losses will be spread widely but thinly over a broad base of capital. However, because the system represents one giant closed loop, no loss will ever leak out of the system, even in conditions worse than the Great Depression.

Third, every cross-guarantee contract must have a minimum number of guarantors, each of whom can bear no more than a specified maximum percentage of that institution's insolvency loss should it fail. For example, a bank or thrift with $100 million of assets must have at least 20 guarantors, no one of which can assume more than 5 percent of that institution's insolvency risk. All institutions with more than $10 billion of assets must have at least 100 guarantors, each of which can assume no more than 1 percent of the institution's risk.

Fourth, each guarantor will be limited as to how much risk it can assume under any one contract and in the aggregate. These limits use the premium paid by a guaranteed institution as the measure of risk assumed. This concept, which reflects the basis on which property and casualty insurance companies are capitalized, recognizes that competitive marketplace pricing will determine with sufficient accuracy the risk of loss under each cross-guarantee contract.

The maximum amount of premium a guarantor can expect to earn annually under any one contract it enters into cannot exceed .09 percent of its equity capital. Further, the aggregate amount of premium income the guarantor is likely to receive over the next 12 months cannot exceed 3 percent of its total capital. A guarantor would have to enter into at least 34 contracts to hit its aggregate premium limit, a fact which ensures that every guarantor will be diversifying its risk if it fully utilizes its capacity as a guarantor. Guarantors, however, would not have to segregate capital in any manner for the cross-guarantee risks they assume; capital serves merely as the way to measure a guarantor's capacity to assume cross-guarantee risks. A guarantor will absorb its actual losses out of its pre-tax profits or, in the case of a very large loss, from its capital.

Regulating Cross-Guarantees

The Petri bill creates a small new agency, the Cross-Guarantee Regulation Corporation (CGRC) to regulate the cross-guarantee

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system (Figure 4). Its most important function will be to review proposed cross-guarantee and stop-loss contracts to ensure that they comply with all of the systemic safety requirements mandated in the bill. However, the CGRC is explicitly barred, in the strongest language possible, from passing judgment on any other feature of these contracts. The CGRC, for example, will be barred from rejecting a contract based on its pricing formula or provisions for taking over a failing institution.

In effect, the CGRC will be comparable to a building inspector; it will merely ensure that the institution has obtained a contract that meets statutory requirements. The marketplace will be the institution's architect, contractor, owner, and operator. Focusing government regulation on just a few rules needed to ensure a sound banking system will give individual banks and thrifts the latitude they need to pursue appropriate business strategies.

To make the cross-guarantee system as regulator-proof as possible, all cross-guarantee contracts will have to be filed electronically in a central electronic repository (CER) operated by the CGRC. Anyone will be able to access the CER at any time to double-check the CGRC's contract approvals and to try to detect any isolated closed loops that the CGRC might have overlooked. The Petri bill even empowers citizens to sue the CGRC to seek enforcement of provisions of the Petri bill that the regulators have ignored.

The Insuring Capacity of the Cross-Guarantee system

Banks and thrifts today have at least 8 times as much capital as is needed to adequately backstop the cross-guarantee system. However, additional capital resources are made available to the cross-guarantee system through the Petri bill's authorization of "nondepository guarantors."

If all banks and thrifts today were guaranteed institutions, their cross-guarantee contracts would guarantee approximately $4.1 trillion of on-balance-sheet liabilities plus off-balance-sheet liabilities with a risk-weighted credit equivalent of another $400 billion. Assuming an average premium rate equivalent to .03 percent of on-balance-sheet liabilities, total premiums paid by guaranteed banks and thrifts would equal about $1.25 billion annually. (Total premiums probably will be less than this amount because actual losses in failed banks will be a small fraction of this amount in the non-deflationary environment cross-guarantees will help to create.)

Given that premiums cannot exceed 3 percent of a guarantor's capital, the entire cross-guarantee system could operate with a $41 billion capital base, an amount equal to just one-eighth of the book

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capital of all banks and thrifts. Hence, there is more than enough capital and earning power within the banking system to safely underpin the entire cross-guarantee system.

As stated above, to give the system access to far greater capital resources, the Petri bill authorizes nondepository guarantors. A nondepository guarantor will function in the same manner as a bank or thrift guarantor, but only after having first obtained a "stop-loss contract" that unconditionally guarantees its performance as a guarantor. Nondepository guarantors can be insurance companies, manufacturing and service firms, pension and endowment funds, and even very wealthy individuals, provided that each nondepository guarantor has a minimum net worth of $100 million.

By serving as an additional source of capital, nondepository guarantors will help ensure that premium rates do not get too high, especially in the aftermath of a large loss. Due to the competitive nature of the cross-guarantee marketplace, past losses should not be rolled into the future in the form of higher premiums. The ability to recover past losses is an unfortunate feature of the present federal deposit insurance monopoly because this recovery process effectively taxes well-managed banks and thrifts to pay for inept government regulation. This effective subsidy of the bad by the good is just one of the many aspects of federal deposit insurance impeding the economic recovery now underway.

Because guaranteed banks and thrifts will automatically qualify as guarantors, if they believe premiums are too high relative to expected future losses, they can sign on to more cross-guarantee contracts as guarantors to capture some of the presumed premium overcharging. This action will enable these institutions to "net down" the cost of their own guarantees and also to bid premium rates back down to a reasonable level. No guaranteed institution, though, will be required to be a guarantor.

Dealing with Failures

Bank and thrift failures will be relatively rare under the cross-guarantee system, largely because market-driven cross-guarantee premiums will deter unwise risk-taking and stimulate turnarounds and recapitalizations, especially in larger banks and thrifts, when losses have weakened the institution. However, failures will occur, largely among smaller institutions that can quickly sink into insolvency. The Petri bill authorizes guarantors to take over a failing bank or thrift if it violates contractual covenants, such as not maintaining sufficient capital relative to the risks it has assumed. Because guarantors will

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have a stronger incentive than regulators to minimize losses, they will close failing banks and thrifts much more quickly. Privatizing the closure decision may turn out to be one of the most important payoffs from cross-guarantees.

Guarantors also will be permitted to take over a guaranteed institution if they cancel its contract or its contract expires and the institution cannot obtain a new contract. By not providing a new contract, the marketplace will have signaled that the institution has failed. However, to protect the integrity of the cross-guarantee system, no bank or thrift will ever be permitted to operate for even one second without having a cross-guarantee contract in force.

Failed banks and thrifts will be resolved under special provisions of the federal Bankruptcy Code rather than in a government-run receivership, as is now the case. Title III of the Petri bill as it will be reintroduced in late 1993 will enact these special provisions. The primary purpose of the bankruptcy proceeding will be to allocate the failed institution's insolvency loss between its guarantors, standing in the shoes of the institution's guaranteed depositors and other guaranteed creditors, and its unguaranteed creditors. However, under no circumstance will the Bankruptcy Court be permitted to alter or compromise the institution's cross-guarantee contract. In effect, an insolvent bank's or thrift's creditors will be protected against any loss whatsoever, regardless of the fate of the failed institution.

Conclusion

Computer technology in less than two decades has made obsolete the traditional regulatory model for banking that evolved over many decades. The new regulatory model proposed in this paper honors the potential of the new technology; likewise, the new technology makes the operation of cross-guarantees more feasible than ever.

Just as the former communist world is shaking off central planning, so too must the market economies discard regulatory models that attempt to micromanage individual banking firms. The time has come to bring *perestroika* to American banking. The Petri bill will do just that.

Apart from bringing much needed deposit insurance reform to banking, the Petri bill will deliver three even greater benefits. Risk-sensitive pricing of cross-guarantees, by promoting wiser lending, will sharply curb the flow of underpriced credit into emerging speculative bubbles, steering the economy away from painful asset deflations. At the same time, cross-guarantees will permit banks and thrifts to

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accurately match their capital and risk-control systems to the financial risks they have assumed, eliminating much of the dangerous and inefficient regulatory arbitraging that has emerged in recent years.Finally, Americans will enjoy greater confidence in the stability of their banks and thrifts through the assurance of a 100 percent guarantee of their bank and thrift deposits and most other depository institution liabilities, without any taxpayer risk.

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Privatizing Deposit Insurance: The Ely Proposal

Gary Gorton

Despite the recent reports of high bank earnings during 1992, apparently due to a fortuitous term structure shift, the U.S. banking system is not well. Over the last 15 years the return on assets or the return on (book or market) equity shows a downward trend (for banks over $300 million in total assets), while charge-offs have been increasing. Moreover, bank failures have been rising at a dramatic rate since 1980, as have FDIC payouts. To address these problems Bert Ely has proposed an innovative revamping of the Federal Deposit Insurance Corporation. The respective proposed law is the "Taxpayer Protection, Deposit Insurance Reform, and Regulatory Relief Act of 1992 (H.R. 6069), introduced by Representative Tom Petri (R.-Wis.). The proposal would privatize deposit insurance, the idea being to free the federal government from the onerous expenses associated with a system that appears to be inappropriate in the current financial environment. In this comment I briefly consider the merits of the Ely proposal.

The Ely Proposal

Briefly, the basic features of the Ely proposal are as follows:

- A system of reinsurance (across private firms) would be mandated to spread the risk of losses on bank deposits;
- Insurance premia would (presumably) be "risk-based" (since the reinsurance market would be competitive);
- The proposal would only be activated if a critical number of institutions opted to join;
- Each reinsuring syndicate (composed of financial and/or nonfinancial firms) would be allowed to employ an agent at the bank being insured in order to "monitor" the bank;

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- The decision to close a bank would be made by the private insurers, rather than by the government;
- Government insurance of deposits would continue during a transition period;
- The federal government would monitor banks only to ensure that they were obtaining the private insurance in accordance with the proposed law.

Privatizing deposit insurance in this way would eliminate the moral hazard problem associated with flat-rate deposit insurance. In theory this problem is due to the fact that bank equityholders have an incentive to add risk to the bank's assets when this risk is not priced and the value of the bank's charter, an intangible asset, is low enough (Merton 1977, Marcus 1990, and Keeley 1990). The proposal shifts the role of monitoring banks from the government, which currently examines and disciplines banks, to the private guarantors.

Banking Panics and the History of Private Insurance

The purpose of deposit insurance is to prevent banking panics. A banking panic is a situation in which depositors at a large number of banks, more or less simultaneously, demand that their deposits be converted into cash in such large amounts that the banking system cannot honor their demands at par. A panic should be distinguished from a bank run in which depositors at a single bank demand conversion of their deposits into cash.

During historical banking panics the banking system was insolvent because bank assets could not be converted into cash to honor depositor demands. The reason for this problem has to do with the unique features of bank loans which, for the most part, make them nontraded securities. Recent research suggests that the role of banks is to monitor borrowers and produce credit-risk analyses of their condition (e.g., Gorton and Kahn 1993). Other securities, particularly corporate bonds, cannot accomplish these goals because the bondholders are dispersed. Consequently, free riding makes monitoring and information production by bondholders difficult.

In order to induce banks to perform these roles it is necessary to put them at risk for nonperformance. Thus, by forcing the bank to hold the loans it originates, bank equity will suffer losses if the bank does not monitor or inaccurately produces information about the borrower. It is difficult to sell loans because if they are sold, the bank has no incentive to perform these functions. Consequently, buyers typically will not be interested in purchasing loans (though see Gorton and Pennacchi 1993).

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As a result of the nontradability of bank loans, bank assets are very difficult to value. There are no market prices of loans and many banks do not have traded equity. In fact, even in modern times it is not clear to what extent bank equity prices provide information which accurately distinguishes one bank from another. Banks may well know the value of their assets, but there is no way for a bank to credibly convey this information to market participants without markets for their assets. Paradoxically, if there were markets for bank loans, we would not need banks in the sense that we have historically understood this term (see Gorton and Pennacchi 1992).

Banking panics happened fairly regularly during the pre-Federal Reserve period of American history: 1857, 1873, 1884, 1893, 1907, and 1914. Banking panics occurred at business cycle peaks when depositors had reason to believe that a recession was coming. During a recession some banks fail because their borrowers fail. Because of the information asymmetry about the value of bank assets, depositors had no way of knowing which banks would fail (Gorton 1985a, 1988; Calomiris and Gorton 1991). Prior to 1914, however, there was a system in which banks themselves privately supplied a form of deposit insurance during banking panics.

Private bank clearinghouses were originally started in the United States (in New York City in 1853) to minimize the costs of clearing checks. But they quickly evolved into organizations which internalized the risk of banking panics. Since individual banks could not convert their assets into cash during a panic, the clearinghouse created an internal market which allowed member banks to discount assets with the clearinghouse and receive "clearinghouse certificates" which (toward the later part of the century) could be used to redeem deposits and functioned as a medium of exchange. These certificates were the liabilities of all the clearinghouse member banks jointly. Consequently, a depositor who received such a certificate in place of a deposit was insured against his particular bank failing (but not against the entire clearinghouse failing—an event which never occurred). In this sense the clearinghouse issued a kind of deposit insurance (Gorton 1985b; Gorton and Mullineaux 1987).

While the clearinghouse system did not prevent panics, the losses on deposits and the number of bank failures was very small, basically an order of magnitude smaller than those that occurred during the Great Depression when neither the clearinghouse system nor FDIC insurance existed. The important features of the clearinghouse system were: (1) the ability to create private money, i.e., the clearinghouse certificates; (2) the ability to monitor member bank risk-taking effectively due to severity of the penalty; (3) secrecy which did not allow

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the public to know which banks were discounting the most assets; (4) the ability to suspend convertibility of deposits into currency.

Without a market for bank assets, the assets cannot be converted into cash in order for banks to demonstrate their solvency to depositors. As a result, in a panic the banking system is insolvent, with the attendant disruptions of the means of payment. The important point is that banking panics are systemic events, that is, the risk which has public policy implications is not the risk of this or that bank being run and failing, but the risk that the entire system becomes insolvent in the specific sense that markets for bank assets do not exist. Any proposal to change the deposit insurance system must be one which does not risk a banking panic.

Assessing the Ely Proposal

In order for the Ely proposal to prevent panics depositors need to believe that the reinsurance system can honor their deposits if there is a banking panic. The reinsurance system essentially substitutes the assets of the insurers for the assets of the insured bank (since bank assets cannot be quickly sold). If there is a panic or a run on an individual bank, the assets of the insurer must be sold to honor the liabilities of the bank. Note that it is not clear that the insurer would know the value of the bank's assets, but, in any case, would be contractually obligated to honor the bank's liabilities.

It appears that the spirit of the proposal concerns the failure of individual banks, rather than a banking panic. The whole idea of reinsurance is that it reduces the likelihood that all of the firms in the insuring syndicate will be insolvent at the same time making it quite probable that a bank's obligations could be honored. Indeed, if one bank fails, then the insurer will not be selling its assets at the same time as all other insurers, and to the extent that the insurer's assets are marketable, they could be sold to honor the banks obligations. But, the failure of individual banks is not the main concern of deposit insurance.

What would happen if there were a banking panic? All insurers would have to convert their assets into cash at the same time. Even if their assets were less information intensive than bank loans, it is not clear that this could occur at prices which would allow the insurers to honor the obligations of all banks at once. This is especially true to the extent that there is mutual insurance, where the loans of one bank are providing the backing for another bank's obligations. (One need only look at the speed with which the Resolution Trust Company (RTC) is selling thrift assets to see how long it takes to sell sizeable amounts.)

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It does not seem obvious that the reinsurance system would be able to honor all banks' deposits during a panic. Note that to determine whether the backing of the insurers is sufficient it is *not* a matter of comparing the total value of the assets of the insurers to the amount of deposits being insured. The total value of the assets is likely to be a different number in the event of a banking panic.

One might imagine that the insurers would hold only assets that are very easy to value, e.g., cash, government securities, high-grade, short-term, commercial paper. In this case, it would be transparent to depositors which banks had insurers which were in trouble because the insurers' assets could be easily valued. This is the logic of narrow banking proposals; the information asymmetry is eliminated at one stroke. In the Ely proposal, however, there are no restrictions on what assets the insuring syndicates would be allowed to hold. In fact, the proposal imagines that other financial firms, such as insurance companies and other banks, would form the syndicates. Since the assets of these firms are difficult to value it seems quite likely that there could be a banking panic under this system.

The proposal does not seem to adequately address the fact that panics are systemic events. Recall that the clearinghouse system was able to avoid the issue of selling assets because of its ability to create money. In the Ely proposal the Federal Reserve's discount window would be available, but it would not be secret (as was the clearinghouse system's discounting procedure). Without secrecy it is not clear that any bank or insurer would use the discount window because such an action would publicly draw attention to that firm's self-perceived weakness. This problem occurred during the Great Depression when the discount window was available, but was not used by banks.

Because the proposal does not address the systemic event of a panic, it is not clear when the insurers would be obligated to honor their liabilities to banks. During a banking panic there is little distinction between the solvency of this or that bank and the solvency of the system. If banks can suspend convertibility, then as information is gradually revealed, this distinction can be made. But, the proposal is phrased in terms of the "failure" of individual banks. If insurers did not immediately honor their banks' liabilities, then the panic is on, and it is of little consequence that at some later date losses might be covered.

The prospect that insurers would not or could not honor banks' liabilities quickly enough raises the question of whether the government would intervene in the event of a panic. The difficulty with this prospect is that if market participants conjecture that the government would, in fact, intervene, then that conjecture can be self-fulfilling.

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In similar experiments with deposit insurance in other parts of the world the government has intervened *ex post.* A recent example of the problem occurred in Chile (de la Cuadra and Valdes 1992). It is difficult to see how the government can precommit to not intervening. The proposal does not address this issue.

Another problem with the proposal concerns the pricing of the insurance premia. That insurance premia would be risk-based presumes that loans can be valued. But, there is a dilemma: if it is possible for market participants (in this case, the insurers) to accurately value (nontraded) loans, then we do not need deposit insurance because there is no longer asymmetric information and, consequently, no danger of panics. Depositors can also value loans and distinguish between banks. On the other hand, if there is asymmetric information, then accurate pricing is not possible and no amount of reinsurance can hedge a systemic risk of banking panic.

The notion of risk-based insurance premia is a limited one. Some improvements in measuring the risk of bank portfolios can be made, because there are degrees of information asymmetry. But, the view that private agents can accurately price the risk of bank loans seems without foundation.

Is Deposit Insurance the Problem?

So far I have assumed that deposit insurance as presently constituted is at the root of recent problems in banking. The argument goes as follows. With flat-rate insurance premia bank equity holders can increase the value of their claims, at the expense of the FDIC, by engaging in riskier activities. Bank equityholders have an incentive to engage in this moral hazard when the value of bank charters is sufficiently low. No one disagrees that if the value of the charter is low enough, or if the value of equity is low enough, that equityholders will behave this way. In fact, this problem appears to have characterized some thrift behavior.

But, thrifts are not commercial banks and simple extrapolation from the experience of thrifts to the situation of the banks is inaccurate. Unlike the thrift industry there has been no large stock which eliminated large amounts of commercial bank equity (like the rise in interest rates during the 1970s did for thrifts). Also, it is clear that banks are valuable franchises even if their charters have lost some value due to competition from nonbanks and new markets.

If deposit insurance is not the problem, then what does explain the recent behavior of the U.S. banking system? In recent work with Richard Rosen (Gorton and Rosen 1992) we argue that the problems emanate from corporate control issues in commerical banking in the

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face of sustained competitive pressure from nonbanks and new markets. We test this hypothesis against the hypothesis of moral hazard due to fixed price deposit insurance. Here I briefly summarize what we found.

One difficulty with the moral hazard argument is that it assumes that equityholders make the lending decisions at banks. But, in fact, managers make such decisions. It is well-known that managers may have different objectives than outside shareholders. For example, empirical evidence for nonfinancial firms suggests that managers are excessively conservative from the viewpoint of outside shareholders.

Whether managers's incentives are aligned with those of outside shareholders or not depends on the amount of stock they own in their bank. If this fraction is very large, then they are essentially the owners and they behave as such. If it is lower, they may be *entrenched,* i.e., it is costly to remove them and they pursue their own interests rather than those of outside shareholders. In the face of competition in which the demand for bank services (on the asset side of the balance sheet) has declined, entrenched bank managers may find that they face no good lending opportunities. Outside equityholders would like to remove these "bad" managers and shrink the bank, moving resources from banking. We show that entrenched managers will make more risky loans in order to gamble on continuation of their jobs. That is, by gambling for high profits they may be able to appear to have good opportunities. This will allow them to keep their jobs. Managers whose interests are aligned with outside shareholders do not mind if the bank shrinks or is closed.

This corporate control hypothesis has a prediction which is the opposite of the moral hazard hypothesis. Simply put, think of a manager with stock ownership of over 50 percent. The moral hazard hypothesis predicts that this will be a bank which engages in risky activities because the equityholder can make this decision unimpeded. But, the corporate control hypothesis argues the opposite: this bank will not engage in risky activities. Rather, banks engaging in risky activities will be those where managers have relatively low stock ownership fraction. Such managers care more about continuing their jobs as heads of large organizations.

We test these two competing hypotheses by examining which types of banks, according to the stock ownership shares of insiders, engage in various kinds of lending activities, ordered by risk and return. The results are clear: the moral hazard hypothesis is rejected in favor of the corporate control hypothesis.

The corporate control hypothesis clearly has much different implications for public policy concerning banks than does the moral hazard

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hypothesis. But, the main point is that casually assuming that commercial banks are akin to thrifts in that deposit insurance is the culprit is not a useful beginning point for proposals to reform bank regulations.

Conclusion

If private firms can assess nontraded bank loans, then so can other market participants, making government deposit insurance and the Ely proposal unnecessary. On the other hand, if banking panics are still a possibility, then the Ely proposal appears incapable of preventing them, making government intervention highly likely. Hence the basic problem presumed by the proposal would not be solved. But, in any case, the proposal presumes that government fixed-rate deposit insurance is the cause of the problems in the banking industry. There is no evidence for this view. On the contrary, the evidence suggests that it is *not* the problem. Consequently, even if the proposal would work to prevent panics, it would not prevent bank failures.

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Financial Reform in Japan and Global Economic Stability

Yoshio Suzuki

The subject of financial reform in Japan and its impact on the global economy is one that intrigues not only the Japenese but foreign observers as well. What has happened to the financial presence of Japan, which loomed so large worldwide in the latter half of the 1980's? More specifically, one may find it difficult to get answers to such questions as why the "bubble" in asset prices in Japan emerged and collapsed, what relation it had with financial reform in Japan, and what implications it has today for global economic stability.

The Bursting of the Bubble: A Result of International Policy Coordination

The emergence and bursting of the bubble in the Japanese asset market was neither a result of financial reform nor of financial deregulation. It was the international policy coordination carried out in the latter half of the 1980s that led to these events. Because of coordinated cuts in interest rates decided upon in the Louvre Accord of February 1987, Japan's ODR was cut to 2.5 percent, an historical low. To be sure, there was no conflict between international policy coordination and domestic stabilization policy at the time of the Accord, since Japan was suffering from a recession brought about by the high yen. In the course of 1987 however the Japanese economy began to recover. At that point in time the optimum policy mix to achieve the twin policy goals of sustained growth with price stability as well as a reduction in the current account surplus would have been a combination of expansionary fiscal policy and neutral monetary policy. This, of course, would have been against the Louvre Agreement because the resulting

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higher interest rates in Japan would have depressed the value of the dollar. (In fact, when Japanese and German interest rates rose slightly in the autumn of 1987, the New York stock market crashed in October, causing the dollar to plummet.) Therefore, in compliance with the Louvre Accord, Japan was obliged to continue its easy monetary policy, keeping its interest rates at the lowest level ever through May 1989. As a result a mistaken notion spread in the Japanese market between 1988 and 1989 that Japan would not be able to raise interest rates lest she create a dollar crisis. This assumption of permanent low interest rates was responsible for the bullish sentiment that caused asset prices to surge beyond the level justified by economic fundamentals, thereby creating the bubble.

However, although Japan is the world's largest surplus and net creditor nation, the yen will begin to fall when overshooting occurs. This, then, is a phase in which a rise in Japanese interest rates will not cause the dollar to collapse. We have been in such a phase since May 1989. Japan's ODR was raised three times in 1989 and twice in 1990, causing the bubble to burst.

The bursting of the bubble has had a broad impact on the Japanese economy. Personal consumption has been sluggish because of the negative wealth effect. Corporate investment has declined for two reasons: first, the deterioration of corporate profits due to investment losses, and second, a decline in the availability of funds resulting from difficulties in equity financing, as well as in borrowing from banks using land as collateral. The negative effects of the bursting of the bubble on consumption and investment are one of the major causes of the present recession.

Banks are beset by a drop in latent profits on the stocks they hold, and by the emergence of bad loans to the real estate sector. As a result, despite six cuts in the ODR by the Bank of Japan since July 1991, the year-on-year growth rate of Japan's broadly-defined money supply continued to decline and was negative between September 1992 and January 1993. Securities companies are chalking up deficits because of drops in commission income caused by a sharp decline in the stock trading volume.

The spill-over effect of the bursting of the bubble on the international front includes the expansion of Japan's current account surplus to 110 billion dollars, equivalent to 3 percent of GNP, caused by an increase in the excess of domestic savings over investments due to the business slump. Moreover, the portion of the surplus that is recycled overseas through direct investments has decreased in recent times. An increasing portion of the surplus is being recycled overseas in the form of repayments of short-term bank debts.

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Toward Autonomy of Economic Policy

Japan has learned at least two valuable lessons from her experiences between the latter half of the 1980s and the early 1990s. The first one concerns her contribution to global economic stability. Japan has experienced the emergence and bursting of the bubble because it defined its contribution to global economic stability in terms of the maintenance of the value of the dollar through a sustained low interest rate policy and the contraction of its current account surplus. As a result, bubbles have formed and burst, the economy has fallen into recession, and the current account surplus has expanded contrary to Japan's aim of contributing to global economic stability and development.

The United States and Japan are economic superpowers to which the "small nation hypothesis" of economic theory does not apply. The stability of the global economy requires that their economies be able to sustain growth without inflation or bubbles, a fact which to me seems to imply that both countries should have autonomy in their economic policies. If one of the superpowers sacrifices its domestic stabilization policy for the benefit of the other superpower, the resultant domestic destabilization will eventually cause serious harm to global stability. The right policy for Japan between 1988 and 1989 would have been a mix of neutral monetary policy and expansionary fiscal policy to achieve sustained growth without the bubble, and to reduce its current account surplus. This policy mix would have raised Japan's interest rates and would have further pushed down the value of the dollar. Surely the two nations could have tolerated this.

The Environment for Financial Deregulation in Japan

The other important lesson for Japan is that we must make haste in implementing financial reform. This is because the formation and bursting of the bubble occurred not as a result of financial deregulation, but because deregulation was delayed. Deposit interest rates will be deregulated completely between 1993 and 1994. Stock brokerage commissions on large transactions will also be deregulated, and the deregulation is expected to be expanded gradually to smaller transactions.

There will also be change in the scope of financial business. Banks will enter the field of corporate bond underwriting, while securities companies will move into trust banking, both using subsidiaries. Initially, the operations of the subsidiaries will be limited, but they will be increased gradually and in stages, with careful monitoring of the functioning of fire walls and the degree and form of competition.

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However, Japan is not aiming ultimately at forming a universal banking system. Japan takes the view that a complete universal banking system may promote oligopolic power of city banks, conflicts of interest, insider information, and the spreading of risk to the payment system, and that contrary to belief it may harm fairness and efficiency. In order to achieve economy of scope, the authorities will seek scope deregulations within necessary limits.

Japanese banks and securities houses have been hard hit by the bursting of the bubble. Will they still have the capacity to take advantage of this scope deregulation in the financial sector?

As the land-price bubble formed and collapsed mainly in large cities, the deterioration of asset portfolios was confined mainly to large powerful banks in major metropolitan areas, such as city banks. This is a lucky condition in an otherwise bleak environment.

Combined statistics for Japanese city banks, long-term credit banks and trust banks show that at the end of September 1992 loans on which interest had not been paid for six months or more stood at 12 trillion yen, most of which were made through their subsidiary non-banks to the real estate sector. The Ministry of Finance announced that 4 trillion yen of this figure was unrecoverable and needed to be written off. Such loans must be increasing now. However on the same date, these banks had latent gains of 15 trillion yen and bad loan reserves of 3 trillion yen, while net operating profits stood at 3.5 trillion yen per annum. This suggests that Japanese large banks have ample ability to correct the deterioration of their asset portfolios due to the bursting of the bubble. By taking advantage of the lessons they have learned, banks are now striving to practice risk management based on prudence and to enhance their net worth.

As regional cities did not experience a land-price bubble, regional banks and credit association banks whose asset portfolios have deteriorated are the exception rather than the rule. The Ministry of Finance and the Bank of Japan are closely monitoring the small number of such exceptions. Large creditor banks have lowered their lending rates to these exceptional small banks or non-banks in order to restore their solvency. If solvency cannot be restored in this way, as in last year's Toyo Shinkin case, these institutions will be split up and the deteriorated parts will be merged with large creditor banks, while the sound parts will be merged with shinkin (credit association) banks in the same region so that depositors will not be hurt. This will diversify the burden on large creditor banks.

In Japan the deposit insurance system has not been mobilized so far. However, the split-up and merger of struggling banks under the guidance of the Ministry of Finance and the Bank of Japan is more

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severe than the mobilization of the deposit insurance system and may effectively prevent moral hazard. The approach to ailing banks in Japan, which is different from the U.S. approach, is partly based on the fact that the number of commercial banks in Japan is only 150, with average assets per bank as high as 38 billion dollars. In the United States the number of insured commercial banks is 12,000, which is eight times as much as in Japan, while average assets per bank amount to only 3 billion dollars, or less than one-tenth of the Japanese average.

Japan has learned many valuable lessons from its recent predicaments. These lessons will enable her to implement financial reform more rapidly and execute the right policy mix to achieve sustained growth without inflation and bubbles, and to reduce its current account surplus thereby contributing to global economic stability.

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BOOK REVIEWS

Public Education: An Autopsy
Myron Lieberman
Cambridge, Mass.: Harvard University Press, 1993, 339 pp.

From the subtitle of Myron Lieberman's new book, I assumed that I would be reading about a public school system that is, as it were, stretched out on a slab. I was prepared to hear Dr. Lieberman's findings on what took the old boy out. As it turned out, however, the Lieberman report indicates that the patient is alive and up and about, and that while he isn't very chipper and his long-term prospects are bleak, the prognosis is for his continued if not exactly vital existence—his condition will fluctuate some, but overall it will deteriorate—for an indefinite period of time.

But if the patient is still alive, if not exactly kicking, what is this autopsy business? What has died? According to the author, a couple of things are indeed dead. One of them is the rationale that has supported government-operated schools, with three principle factors being involved in its demise. The first are major social and demographic changes, an aging population being one example. The second has to do with educational policies and practices that contribute to a loss of public support. For instance, school goals and programs dealing with sex education and religion lead to conflict and antagonize important constituencies. The third factor is the growing awareness, particularly in light of recent historical events in the former Soviet Union and Eastern Europe, of the superiority of the market system. In Lieberman's view, it will become increasingly clear to more and more people that America has been prosperous and democratic not because of government provision of education but in spite of it. On this last one, I hope he is right, because, carrying over the health metaphor, the ideology of managerial liberalism is looking pretty fit to me these days.

So the rationale for public education as we have known it has died. What else? The hope that reform will save the system, that too has died, says Lieberman. True, adjustments here and there may help it stagger on for a while, but ultimately the public school system is a lost cause; nothing will rejuvenate it. Which is not to say that individuals and groups won't try. After all, many feel a loyalty and affection for it or believe that we couldn't do without it, and that the latest elixir will do the trick. Then too, of course, there are some, teachers unions and others, who see it as

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their meal ticket, although of course they wouldn't put it so crassly. That wouldn't be politic, and besides, it is a fact of life that people come to sincerely believe in whoever or whatever puts food on their table and gives them a place in the scheme of things. Anyway, expect a flood of attempts from various directions to give a shot in the arm to government schools, whether it be through the formulation of new goals or testing procedures, higher graduation requirements, choice within public schools, school-based management, teacher empowerment, alternative routes to teacher licensing, peer review, parent involvement, textbook improvement, cooperative learning, mastery learning, whole language approaches to reading, merit pay, career ladders, moving away from age-grading, accelerated learning—you name it. Some of this will help a little, and some will actually make things worse, but Lieberman's point is that none of it will make a significant difference in the power structure of education, the way education is carried on, or student achievement. What it will do, however, is keep a system alive that ought to have the plug pulled on it, spread false hope that it can be saved, drain resources more usefully put elsewhere, and keep America from getting on with its educational life. Thus the image you get from Lieberman is of a decrepit old codger wheezing and limping along surrounded by well-wishers and hangers-on propping him up with crutches, handing him pills, and, not a few of them, rifling his wallet for money (money that he got from you and me, by the way).

Public Education: An Autopsy comes down to an argument for a market system in education: where new suppliers of education are able to enter the market to meet increased demand, where capital and labor can flow into and out of production in response to changes in demand, where inefficient producers must become efficient or go out of business, where buyers and sellers have accurate information about the service, and where no buyer and no seller can control enough of the market to set prices or quantities—needless to say, an arrangement that we don't have now. Lieberman's thesis is that only a market system will bring major improvements in America's schools. His contention is that schools for profit—schools set up like any other business, to return a profit for those who invest their money and effort in them—are essential to the existence of a market system in education.

The distinction between nonprofit and for-profit schools is a crucial one to Lieberman. As an illustration of its importance, many analysts assume that vouchers and/or tuition tax credits for nonprofit schools will create a market system. While Lieberman makes it clear in the epilogue of the book that when the issue of vouchers or tax credits presents itself, such as in the recently defeated California initiative, he stands with the choice advocates, he also cautions that these arrangements won't necessarily lead to the market system he finds imperative. In the coming years, Lieberman envisions a three-element educational industry made up of government schools, private schools, many of them denominational, and for-profit schools.

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In this book, Lieberman demonstrates a keen and informed mind and brings to his writing the savvy and insider's perspective that comes from 45 years in education. He is the author of a number of books on education beginning as far back as 1956. He writes well, and with good humor, although the book is quite a long read.

Lieberman provides as much data and as many cogent arguments on this topic as anyone could reasonably expect—thorough is a word that applies to him. Nevertheless, I am left with some questions. For instance, assuming a market system in education is a good thing, is it enough to get us what we want? Is there more to it than that? Is a market arrangement but one necessary piece in the puzzle? How much do we also have to attend to, say, individual and collective values, or social and political realities, as well as markets? And if Lieberman is right and voucher plans won't necessarily lead to a market system, how enthusiastic should we be about them? Is there any chance that vouchers will get in the way of local control and take one more important responsibility away from people, in this case the education of their own children? Will vouchers or tax credits serve to lock in education as another product to buy and consume and thereby rob people of the satisfaction of creating something that reflects who they are? Will an unintended outcome of voucher plans be the government's getting its hands on private schools and imposing on them what it has already done to public schools, its usual number: bureaucratization, standardization, and "mediocritization" (also known as the post office syndrome), all the while steadily making pitches for more and more resources? Minneapolis is turning its schools over to a private company to run. How excited should we be about that?

Yes, I've got questions. But then again, a good book both informs you and gets you thinking—and Lieberman's book has done that for me.

Robert Griffin
University of Vermont

The Moral Sense
James Q. Wilson
New York: The Free Press, 1993, xviii + 313 pp.

James Q. Wilson holds that human beings share a common moral sense. Underlying the diverse moral rules and customs we find in different cultures and historical periods, he claims, are a set of dispositions and emotions that have a common ethical content. The purpose of his book is to describe that moral sense, to explain its sources, and—implicitly at least—to endorse it.

In content, according to Wilson, the moral sense prescribes *sympathy* (it is obligatory to avoid cruelty to others and admirable to extend them compassion and aid; self-sacrifice on their behalf is especially admirable); *fairness* (goods should be distributed equitably, favors returned, and

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people judged impartially); *self-control* (one ought to control short-term impulses for the sake of long-term goals and obligations); and *duty* (obligations should be honored even in the absence of rewards or punishments). Wilson notes that the individualistic cultures of Western Europe and especially America tend to emphasize fairness and sympathy, whereas the communitarian cultures of Japan and elsewhere in East Asia tend to emphasize duty and self-control. Nonetheless, he claims that every society endorses all four principles in some form.

Wilson is considerably less clear in describing what the moral sense is as a mental state. He appropriates the concept of a "moral sense" from Francis Hutcheson, Adam Smith, David Hume, Thomas Reid, and other thinkers of the 18th century. One of the central debates in this tradition was whether the moral sense is affective (a feeling or sentiment) or cognitive (a literal sense, like vision). Wilson seems to side with the former camp. He describes it as a feeling, compares it with desires, and speculates that its seat is the limbic system in the brain, known to be involved in various basic emotional responses. Yet he also describes it as a belief or set of judgments; and in many specific cases he treats it as the product of thought. Describing duty, for example, he refers favorably to Hans Eysenck's theory that it is the product of classical conditioning of the autonomic nervous system, yet he also says that "it is in part something we impose on ourselves as we think through what it means to be human and on what terms we can live with ourselves"—a straightforward cognitive account.

Wilson argues that the moral sense is a product of many factors: genetic endowment, stimulus-response conditioning, economic incentives, cultural influences, and child-rearing practices, among others. But its fundamental source is the desire for affiliation or attachment with other people, and especially the reciprocal bonds between parents and children. "Our moral senses are forged in the crucible of this loving relationship and expanded in the enlarged relationships of families and peers. Out of the universal attachment between child and parent the former begins to develop a sense of empathy and fairness, to learn self-control, and to acquire a conscience that makes him behave dutifully at least with respect to some matters. Those dispositions are extended to other people. . .to the extent that these others are thought to share in the traits we find in our families" (226).

One problem with Wilson's defense of this hypothesis is that he takes for granted the conventional distinction between self-regarding and other-regarding motives, and the accompanying view that only the latter count as moral impulses. Wilson's theory gains much of whatever plausibility it has from this assumption that morality is social in content and function. But he does not examine or defend that assumption and seems oblivious to some of the peculiar things it leads him to say. For example, he says that valuing self-esteem is an other-regarding motive—apparently because it does not fit the usual conception of self-interest.

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The concept of self-esteem points to another problem in Wilson's theory. Self-esteem is in part a sense of self-worth, of having lived up to one's moral standards. Why do we value this? Wilson claims that as social animals we desire the approval of others—and not merely as children who are dependent on our parents. Even as adults, he says (in a generalization he takes as self-evident), "Scarcely a waking hour passes when we do not wonder how we appear in the eyes of others." This is the root from which he thinks the moral sense grows.

Yet he is aware that virtue is not a popularity contest. "Since we want to be admired, we want to conform, within reason, to the expectations of others," Wilson writes. "But at some point a remarkable transformation occurs in how we judge ourselves. We desire not only to be praised, but to be praiseworthy." What is the nature of this "remarkable transformation"? What is the psychological mechanism by which the child's desire for its parents' approval matures into the kind of moral strength that can act for an ideal in the face of social ostracism? Wilson does not say; he admits it "is not well understood." But if we do not know *how* morality arises from the desire for approval, then what reason do we have for assuming there is a causal link in the first place? Why assume that the moral sense arises from a desire for approval, rather than, say, a recognition that one's own long-range interests require that one act in accordance with certain principles? This is not to deny that for most societies historically, and for many individuals even today, morality does have tribal roots. The question is whether this is a matter of psychological necessity.

A final problem concerns the normative import of the book. Wilson claims at the outset that he is not trying "to state or justify moral rules" nor "to discover 'facts' that will prove 'values.' " As a social scientist, his goal is merely to describe the facts. Yet he clearly has a normative end in view. He is clearly concerned, for example, that the moral relativism so common today is weakening the bonds that make society viable. He praises the Enlightenment for promoting individualism and universalism, under the rubric of individual rights, but worries about "the challenges to self-control and duty posed by radicalized individualism. If rights are all that is important, what will become of responsibilities?"

Speaking more generally, he insists that our moral sentiments must be treated as valid: "There are many ways of knowing; the teachings of the heart deserve to be taken as seriously as the lessons of the mind." But it simply is not possible to spin normative gold from this sort of straw. Emotions are not tools of cognition, and neither is majority opinion.

Wilson's book is best seen as a modern statement of the classical conservative thesis, going back at least to Edmund Burke, that morality is a matter of emotion, not reason; that it is rooted in the impulse to emulate and seek approval from those to whom we feel attached; and that the circle of attachments spreads outward from the family.

Wilson sets this view in the context of a wide range of work in psychology, anthropology, history, economics, and game theory. That makes his book a useful one for those who want a survey of what social science has

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to say about morality as human beings actually experience and practice it. And his commentaries on this literature are often insightful. But in the end, the empirical evidence he reviews does not add up to a proof of the conservative theses.

David Kelley
Institute for Objectivist Studies

The Wisdom of Henry Hazlitt
Henry Hazlitt
Irvington-on-Hudson, N.Y.: Foundation for Economic Education, 1993, 358 pp.

A few months before Henry Hazlitt's death on 8 July 1993 at the age of 98, the Foundation for Economic Education republished 31 of his essays from its monthly magazine *The Freeman*. They follow an Introduction by Hans F. Sennholz, tributes written by Bettina Bien Greaves and Edmund A. Opitz for Hazlitt's 95th birthday in 1989, and Ludwig von Mises's tribute on Hazlitt's 70th birthday in 1964. Hazlitt's autobiographical response at the 1964 celebration is also included.

The reprinted essays date from 1956 to 1985; 1971 is their median year. A few of them also appeared as parts of his books. Recurring topics include the logic of a market economy, the calculation-and-knowledge problem of socialism, poverty and welfare programs, growth of government intervention, and the uphill battle facing libertarians. Noting the bias implicit in speaking of the "private" and "public" sectors of the economy, Hazlitt suggests sometimes substituting the more forthright terms "voluntary sector" and "coercive sector."

Libertarians are handicapped, as Hazlitt says, in having to debate with bureaucrats and special-interest spokesmen who, unlike themselves, naturally have technical expertise and the details of government programs and interventions at their fingertips. In several of his articles, nevertheless, Hazlitt deploys a remarkable variety of facts and figures. He shows that he is no mere ivory-tower philosopher of freedom.

Yet he *is* a philosopher. He dissects the prize-winning *Anarchy, State, and Utopia* (1974), in which Robert Nozick tries to legitimatize the state, though only a minimal state, as opposed to anarchy. He faults not so much that conclusion as the defective arguments that Nozick employs and his rambling, involuted, "self-heckling" style. Nozick rejects any form of utilitarian justification of his position and even caricatures utilitarianism.

Hazlitt identifies the attempt of Nozick and some other libertarians to ground their policy preferences in "natural law" or "natural rights," as in John Locke's self-ownership axiom. Hazlitt traces the appeal of natural law largely to its ambiguity. No two of its votaries seem to agree on just what it enjoins. Hazlitt quotes Jeremy Bentham: "A great multitude of people are continually talking of the Law of Nature; and then they go on giving you their sentiments about what is right and what is wrong:

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and these sentiments, you are to understand, are so many chapters and sections of the Law of Nature."

The terminology of natural rights and natural law, Hazlitt notices, has helped perpetuate an unfortunate mystique, suggesting entities "independent of the human will, independent of consequences, inherent in the nature of things." He embarks on demystification, rejecting "vague and easy rhetorical solutions." The notion of rights is indeed sensible if we understand the term to mean *ideal* rights, the legal rights everyone *ought* to enjoy. (The concept of rights originated as a legal concept, says Hazlitt—how correctly I do not know—but it became extended into a concept of *moral* rights as well.) Rights imply duties: one's person's right implies the duty of one or more other people to fulfill or respect it. "If we abandon this two-sided concept the term *right* becomes a mere rhetorical flourish without definite meaning."

Left-liberals often try to stretch the concept of rights to mean entitlements to all sorts of good things, like adequate incomes and paid vacations. Hazlitt sees through these pseudo-rights. He also punctures the attempt to simplify all rights down to one single right to equality of consideration. (Nowadays Ronald Dworkin's postulate of "equal concern and respect" comes to mind, but Hazlitt traces the flawed attempt to Hastings Rashdall in 1907.)

Hazlitt distinguishes between absolute rights, which seldom if ever occur, and prima facie rights. Subject to certain conditions and within necessary qualifications, however, he maintains that legal and moral rights "are or ought to be *inviolable.*"

"This inviolability does not rest on some mystical yet self-evident 'law of nature.' It rests ultimately (though it will shock many to hear this) on utilitarian considerations. But it rests, not on *ad hoc* utilitarianism, on expediency in any narrow sense, but on *rule* utilitarianism, on the recognition that the highest and only permanent utility comes from an unyielding adherence to *principle.* Only by the most scrupulous respect for each other's imprescriptible rights can we maximize social peace, order, and cooperation."

The reprinted article on "Rights" is almost identical with chapter 28 of his *The Foundations of Morality* (1964). This, my own favorite among Hazlitt's many books, deserves all the emphatic recommendations it can get.

Hazlitt grounds his own libertarian position on a sophisticated rule, or indirect, utilitarianism. Like Ludwig von Mises, he focuses on the requirements of social cooperation—the institutions, laws, ethical precepts, behavioral dispositions, and character traits necessary for people to live together peacefully, coordinate their efforts, and reap the gains from sociability, specialization, and trade. Arguing that justice does not stand in tension with utility but serves it instead, Hazlitt reminds us of the eloquent chapter 5 of John Stuart Mill's *Utilitarianism.* He also shows how even John Rawls, celebrated author of *A Theory of Justice* (1971) and avowed Kantian and contractarian foe of utilitarianism, is in fact a

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crypto-utilitarian. Gratifyingly, and rather by way of exception in libertarian circles, both Sennholz and Mrs. Greaves, in their introductions, show knowledgeable sympathy with the philosophical position of Hazlitt and Mises.

Among several other topics Hazlitt touches on in his newly collected essays is "The Art of Thinking," his title for an epilogue to the 1969 reprinting of his first book, *Thinking as a Science*, which he published in 19__ at the age of 21. Hazlitt expounds his strategy of lifelong self-education. Refreshingly, though perhaps uncharacteristically for someone so closely associated with Mises and the modern Austrian school of economics, Hazlitt shows a convincing sympathy for mathematics, among other fields of scholarship. A section on "Words Sharpen Observation" presents psychological insights, apparently independently arrived at, much like those that F. A. Hayek expounds in *The Sensory Order* (1952). Expressing an insight that should be preached to students who say they can scarcely begin writing their theses before getting their thoughts straight and almost completing their research, Hazlitt explains how writing can be an invaluable aid to thinking itself.

Hans Sennholz says that although Hazlitt "thought as wise men do," he "wrote as the common people speak." Not so. Phone calls to radio and television talk shows—as well as rambling discourses at university faculty meetings—furnish evidence that the lucidity and simplicity of Hazlitt's writing style are rare virtues in actual speech. Conceivably Hazlitt had a truly exceptional facility, but most writers achieve a style as good as his either not at all or only through laborious self-editing and rewriting.

Leland B. Yeager
Auburn University

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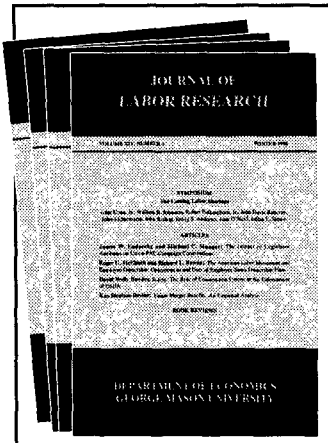

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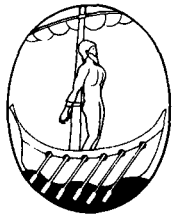

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THE DYNAMIC GAINS FROM TRADE

Trade links together markets in different places. It serves as a kind of safety valve or shock absorber, allowing random economic disturbances in different places partially to offset each other. Disturbances like a local crop failure or a local temporary glut of a particular product are less serious in a world united by trade then in an isolated local market. In this way trade resembles insurance. Just as a loss spread over many policyholders through insurance premiums is less damaging than the loss each person would otherwise risk having to bear alone in full, so spreading around the risk of local disturbances is advantageous. Furthermore, the interconnection of markets is self-reinforcing: opportunities for trade promote the development of specialized trading firms, warehousing, commodity specialists and communications and market-reporting services, standardization of commodity grades, organized commodity markets with the futures trading and hedging facilities that they provide, arbitrage and speculation, banking facilities geared to the needs of international trade, credit reporting, international parallelism in commercial law, and commercial arbitration facilities. It also keeps businessmen alert to new markets for their goods and services and alert to new ideas they may discover abroad and adopt at home.

—Leland B. Yeager and David G. Tuerck

Trade Policy and the Price System
(Scranton, Pa.: International Textbook Co., 1966), p. 62.

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